Tax Policy and the Obligation to Support Children

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This Article explores how the tax liability of parents should be affected by the obligation to support their children.[1] Children are certainly an economic burden; family resources that otherwise could be used to purchase goods satisfying the parents' needs must be used for support of the children. But, of course, children are much more than a burden. Parents hope and expect that their children will be a source of happiness and fulfillment. They want their values to be transmitted to their children, and perhaps their yearning for immortality can be realized, in part, through their children. Because children have a profound and multifaceted impact on their parents, issues involving tax consequences of children are complex and controversial.

The Article first reviews the personal exemption, head of household status, and the earned income credit, which are provisions in current law granting tax benefits with respect to children.[2] The discussion illustrates that the tax benefits depend on the parents' marital status, income, and number of children and that the allocation of these benefits is frequently anomalous. In the second section the Article critically discusses the various approaches that have been suggested

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[1] There are many other issues connected with tax liability and children, but they are generally not discussed in this Article. In particular, tax treatment of childcare expenses incurred so that parents may work is not addressed because special treatment for these expenses is premised on the connection with earned income, not on the general effect of children on ability to pay. *See generally* I.R.C. §§ 21, 129 (1994). The Article also ignores any arguments that there should be either a tax penalty or subsidy for children pursuant to a population policy. For an excellent, recent article that discusses both issues, see Lawrence Zelenak, *Children and the Income Tax*, 49 TAX L. REV. 349 (1994). Finally, the Article does not discuss what requirements (such as maximum age or earnings of a child) should be satisfied for the parent to be allowed a deduction or other tax benefit. For a thorough discussion that is still useful, see Deborah H. Schenk, *Simplifying Dependency Exemptions: A Proposal for Reform*, 35 TAX. LAW. 855 (1982) [hereinafter *Dependency Exemptions*]. *See also* Deborah H. Schenk, *Simplification for Individual Taxpayers: Problems and Proposals*, 45 TAX L. REV. 121, 130–35 (1989).

[2] The childcare credit and the exclusion from income pursuant to an employer sponsored dependent care program are not discussed because they are only available to the extent the taxpayer has made qualifying expenditures or used appropriate services. *See* I.R.C. §§ 21, 129 (1994); *supra* note 1.

for taking account of children's effect on their parents' ability to pay tax. These include a deduction for the subsistence cost of raising a child, a deduction for the estimated actual cost, income splitting between parents and children, and a tax credit. There are, however, theoretical and practical problems with each of these approaches, and none satisfactorily determines the effect of children on the proper tax liability of parents at all income levels. In the third section the Article undertakes a basic examination of the effect of children on ability to pay. It concludes that low and middle income parents should be allowed a deduction (or equivalent benefit) for each child that at least equals the subsistence cost of raising a child, but that the benefit need not be extended to affluent parents. Other goals of the tax system, such as low marginal rates and vertical equity, may influence the decision concerning appropriate allowances for affluent parents. The fourth section of the Article discusses the policy implications of these conclusions. The major recommendation is that the current $2500 personal exemption for each child be replaced by a $600 credit. It is also suggested that the separate tax schedule for heads of households be repealed, but that an increased credit for unmarried parents may be justified. Finally, recommendations for improving and possibly restructuring the earned income credit are also offered.

The primary objective of this Article is to explore how children affect parents' ability to pay tax. It can, of course, be argued that parents should be encouraged to make expenditures benefiting children and that therefore tax benefits with respect to children should exceed their effect on ability to pay.[3] One problem with this argument is that there is no assurance that most of a family's reduction in tax liability will be spent in a way that benefits the children. In addition, policy makers should know what a neutral tax policy is before enacting provisions designed to benefit families with children. Otherwise, they cannot intelligently evaluate whether proposed benefits are too great or too small. Therefore, this Article concentrates on determining what a neutral tax policy with respect to children should be. Not surprisingly, there is no simple answer.

I. REVIEW OF CURRENT LAW

Current law provides a variety of benefits with respect to children. As the discussion in this section illustrates, however, the results are frequently anomalous, and Congress has usually not provided a satisfactory rationale for its decisions. The inescapable conclusion is that there is no underlying theory

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[3] Certain proposed tax benefits, such as tuition credits, are intended to subsidize or encourage specific activities. This Article, however, only discusses allowances for the general costs of raising a child.

and that many of the decisions have been made on an ad hoc basis.

A. *The Personal Exemption*

Taxpayers are generally allowed personal exemptions for themselves, children they support who are eighteen years old or under (twenty-three if a student), and other relatives or members of their household with low incomes whom they support.[4] Personal exemptions for children and other dependents were claimed on 36% of 1994 individual returns, and the overwhelming majority of these exemptions were for children.[5] They were widely used by taxpayers of all income levels; for example, 56% of returns with adjusted gross income over $100,000 and 33% of returns with adjusted gross income between $10,000 and $15,000 deducted personal exemptions for dependents.[6] The personal exemption, which is $2500 for 1995 returns,[7] has been part of the tax laws for many years,[8] and since the mid-1940s the amount of the deduction for a dependent child has been the same as for the parent.[9]

Because the personal exemption is allowed as a deduction, the amount of tax saved for each child depends on one's tax bracket and is thus worth more to high income taxpayers. A person in the 15% bracket saves $375 per exemption; a person in the 31% bracket saves $775.[10] However, for very high

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[4] I.R.C. §§ 151, 152 (1994). However, a person cannot deduct a personal exemption for herself if others (such as her parents) are allowed a personal exemption for her. I.R.C. § 151(d)(2) (1994).

[5] INTERNAL REVENUE SERVICE, STATISTICS OF INCOME BULL. 32 (Fall 1995) [hereinafter STATISTICS]. Exemptions for dependents were deducted on 39,133,000 returns; exemptions for children at home were deducted on 36,645,000 returns; and exemptions for children away from home were on 687,000 returns. *Id.* Because exemptions for both children at home and children away from home can be deducted on a single return, it is not clear exactly how many returns included exemptions for children.

[6] *Id.*

[7] Rev. Proc. 94-72, 1994-2 C.B. 811, 814. This amount is indexed annually for inflation. I.R.C. § 151(d)(4)(A) (1994).

[8] *See* Revenue Act, 1916, Pub. L. No. 271, § 7, 39 Stat. 756, 761 (codified as amended at I.R.C. § 151 (1994)).

[9] *See* LAWRENCE H. SELTZER, THE PERSONAL EXEMPTIONS IN THE INCOME TAX 38–43 (1968). For 1944 and 1945, the uniform per capita exemption was applicable only to the surtaxes, not to the "normal tax." *Id.* In 1946 a $500 uniform exemption became fully effective. *Id.* Prior to 1944, the deduction for a dependent was smaller than for a single taxpayer. *Id.*; Gerard Brannon, *Commentary*, *in* TAXING THE FAMILY 104 (Rudolph G. Penner ed. 1983); *Dependency Exemptions*, *supra* note 1, at 855–60.

[10] A greater tax saving for high income taxpayers does not necessarily mean that repealing the personal exemption would make taxes more progressive. The tax saving from the personal exemption could still represent a higher percentage of the tax liability of low

income taxpayers personal exemptions are phased out. For a married couple filing jointly, the personal exemptions on 1995 returns start to decline when adjusted gross income is $172,050, and are fully phased out when adjusted gross income is $294,550.[11] The phaseout was introduced in the Tax Reform Act of 1986, at the same time the personal exemption was increased from $1080 in 1986 to $1900 in 1987 (and eventually to $2000 in 1989).[12] Committee reports indicated that the personal exemption was increased to remove most taxpayers below the poverty threshold from the tax rolls,[13] but did not give any rationale for the phaseout.[14]

In the Technical and Miscellaneous Revenue Act of 1988,[15] Congress "clarified" that deductions for personal exemptions are not allowable when computing tax liability under the alternative minimum tax,[16] which an

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income persons than high income persons. *See* SELTZER, *supra* note 9, at 98 n.22; Zelenak, *supra* note 1, at 364 n.71.

[11] Rev. Proc. 94-72, 1994-2 C.B. 811. For an unmarried person filing as head of household, the phaseout begins when adjusted gross income is $143,350, and personal exemptions are fully phased out when adjusted gross income is $265,850. *Id.* These amounts are indexed annually for inflation. I.R.C. § 151(d)(4)(B) (1994). For discussion of filing as head of household, see *infra* notes 20–35 and accompanying text.

[12] Tax Reform Act of 1986, Pub. L. No. 514, §§ 101(a), 103, 100 Stat. 2085, 2097–98, 2102–03 (codified at I.R.C. § 151 (1994)). *See generally* H.R. REP. NO. 99-841, 99th Cong., 2d Sess. II-7 to II-10 (1986), *reprinted in* 1986-3 C.B. (Vol. 4) 1, 7–10. Until the Omnibus Budget Reconciliation Act of 1990, the personal exemptions, as well as the benefit of the 15% bracket, were phased out by the imposition of an additional tax liability equal to 5% of taxable income within a specified range. *Id.* The direct phaseout of personal exemptions was introduced by OBRA of 1990, but was originally temporary. Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, § 11104(a), 104 Stat. 1388, 1388–407 (codified at I.R.C. § 151(d) (1994)). The direct phaseout of personal exemptions was made permanent in 1993. Revenue Reconciliation Act of 1993, Pub. L. No. 103-66, § 13205, 107 Stat. 416, 462.

[13] S. REP. NO. 313, 99th Cong., 2d Sess. 31–33 (1986), *reprinted in* 1986-3 C.B. (Vol. 3) 1, 31–33; H.R. REP. NO. 426, 99th Cong., 1st Sess. 82–83 (1985), *reprinted in* 1986-3 C.B. (Vol. 2) 1, 82–83. For discussion of this legislative history, see *infra* note 124.

[14] *See* Zelenak, *supra* note 1, at 367. The Revenue Reconciliation Act of 1993 made the phaseout permanent. *See supra* note 12. The report of the House of Representatives Committee on the Budget that accompanied RRA of 1993 stated that the purpose of the phaseout was to "enhance" progressivity. H.R. REP. NO. 111, 103d Cong., 1st Sess. 635 (1993), *reprinted in* 1993-3 C.B. 167, 211.

[15] Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, § 1007(b)(2), 102 Stat. 3342, 3428 (amendments related to § 55 of the Tax Reform Act of 1986).

[16] H.R. REP. NO. 795, 100th Cong., 2d Sess. 88 (1988); S. REP. NO. 445, 100th Cong., 2d Sess. 94 (1988), *reprinted in* 1988 U.S.C.C.A.N. 4515, 4612. The Technical

individual must pay if it exceeds his regular tax liability.[17] The minimum tax primarily affects a small number of high income persons who have excessively utilized various tax preferences and itemized deductions.[18] The only explanation provided for disallowing the personal exemptions was that a minimum tax exemption amount already existed.[19] This explanation, however, is not very helpful since the exemption amount does not vary according to the number of dependents.

B. *Head of Household Status*

An unmarried person who maintains a household in which she lives with one or more children generally qualifies as a "head of household"[20] and is entitled to three significant benefits in addition to the personal exemptions. Unlike the personal exemption, these benefits are entirely realized with the first child; they do not increase if there are additional children.

The original benefit of qualifying as head of household is a more favorable rate schedule than that available to most unmarried persons. Congress first enacted a separate schedule for heads of households in 1951,[21] three years after the benefit of income splitting had been extended to married couples filing jointly.[22] When enacted in 1948, income splitting generally taxed a married couple at twice the amount payable by a single person with half of the couple's

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and Miscellaneous Revenue Act of 1988 disallowed the personal exemption retroactively, providing that its effective date be determined as if it originally had been included in the Tax Reform Act of 1986. Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, §§ 1007(b)(2)(E), 1019(a), 102 Stat. 3342, 3428, 3593.

[17] I.R.C. § 55(a) (1994).

[18] Liability is computed by using a larger tax base and lower rates than are used for the regular income tax. *See* I.R.C. § 55(b) (1994). There are, however, fairly large exemptions that are phased out for high income taxpayers. *See* I.R.C. § 55(d) (1994). Less than .3% of individual returns were subject to the alternative minimum tax in 1994. *See* STATISTICS, *supra* note 5, at 29-30 (Table 5).

[19] *See* H.R. REP. NO. 795, 100th Cong., 2d Sess. 88 (1988); S. REP. NO. 445, 100th Cong., 2d Sess. 94 (1988), *reprinted in* 1988 U.S.C.C.A.N. 4515, 4612.

[20] *See* I.R.C. § 2(b) (1994). A person may be a "head of household" if she either maintains a household for dependents and lives in that household or maintains a household for a parent. *Id.* A person who qualifies as a "surviving spouse," however, is not a head of household. I.R.C. § 2(b)(1) (1994). Among other requirements, a surviving spouse must maintain a household for a dependent child and must survive a spouse who died within two years preceding the taxable year. I.R.C. § 2(a)(1)(A) (1994). A surviving spouse is generally taxed the same as a married couple who files a joint return. *See* I.R.C. §§ 1(a), 63(c)(2)(A), 151(d)(3)(C)(i) (1994).

[21] Revenue Act of 1951, Pub. L. No. 183, § 301, 65 Stat. 452, 480-83.

[22] Revenue Act of 1948, Pub. L. No. 471, § 301, 62 Stat. 110, 114-16.

income. In effect, it attributed half the couple's income to each spouse for tax purposes and could be justified as reflecting the way that economic resources are shared.[23] However, income splitting between spouses was perceived as unfair to unmarried persons who had family responsibilities since it reduced the tax burden of most married couples below that of single persons with the same income.[24] Consequently, Congress determined that the benefits of income splitting should be partially extended to a person who qualified as head of household,[25] and fixed her tax liability midway between that of a married couple and a single person with the same income.[26] Congress made this change without any investigation into the costs of raising children and the special burdens of being a single parent.[27]

Table I illustrates the current savings (using the 1995 schedule) available to an unmarried person who can file as head of household. There is no benefit to those with taxable income of $23,350 or less, but, for taxable incomes above that amount, the tax savings increase as income increases. The tax savings, however, generally become a smaller percentage of taxable income. The savings are $864.50 for a person with $30,000 taxable income and increase to a maximum of $2,395.50, which is realized by a person with taxable income of $130,800. Unlike the personal exemption (which is phased out at high incomes), tax savings from filing as head of household remain no matter how high taxable income becomes.

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[23] *See* Michael J. McIntyre & Oliver Oldman, *Taxation of the Family in a Comprehensive and Simplified Income Tax*, 90 HARV. L. REV. 1573, 1592–99 (1977). When it enacted income splitting in 1948, Congress was responding to the differing tax treatment of married couples in community property and other states. *See* Glenn E. Coven, *The Decline and Fall of Taxable Income*, 79 MICH. L. REV. 1525, 1536–37 (1981).

[24] *See* Boris I. Bittker, *Federal Taxation and the Family*, 27 STAN. L. REV. 1389, 1417 (1975).

[25] H.R. REP. NO. 586, 82d Cong., 1st Sess. (1951), *reprinted in* 1951 U.S.C.C.A.N. 1781, 1788–91.

[26] *See* Bittker, *supra* note 24, at 1417. In 1969, Congress enacted a new schedule for unmarried persons that reduced their taxes relative to those of married persons. Tax Reform Act of 1969, Pub. L. No. 91-172, § 803, 83 Stat. 487, 678–83. *See* Bittker, *supra* note 24, at 1428–29.

[27] *See* Coven, *supra* note 23, at 1537.

TABLE 1
SAVINGS FROM HEAD OF HOUSEHOLD SCHEDULE[28]

(1) Taxable Income	(2) Tax for Unmarried	(3) Tax for HH	(4) Savings from HH (2)-(3)	(5) Savings % of TI (4)/(1)
$10,000	$1,500.00	$1,500.00	$0.00	0.00%
$20,000	$3,000.00	$3,000.00	$0.00	0.00%
$30,000	$5,364.50	$4,500.00	$864.50	2.88%
$40,000	$8,164.50	$7,137.50	$1,027.00	2.57%
$50,000	$10,964.50	$9,937.50	$1,027.00	2.05%
$60,000	$13,868.00	$12,737.50	$1,130.50	1.88%
$80,000	$20,068.00	$18,337.50	$1,730.50	2.16%
$100,000	$26,268.00	$24,515.00	$1,753.00	1.75%
$150,000	$43,370.50	$40,975.00	$2,395.50	1.60%
$200,000	$61,370.50	$58,975.00	$2,395.50	1.20%
$500,000	$178,136.50	$175,741.00	$2,395.50	0.48%
$1,000,000	$376,136.50	$373,741.00	$2,395.50	0.24%

A more recent benefit of filing as head of household is the increased standard deduction that Congress established in 1986.[29] The standard deduction for a head of household, which had been the same as that usually available to a single person, was set at 70% of the difference between that of a single person and that of a married couple filing jointly. The committee reports state that "the costs of maintaining a household for an unmarried individual and a dependent more closely resemble the situation of a married couple than that of a single individual without children,"[30] but there was no further justification of the amount chosen.

The standard deduction, a fixed amount used in lieu of itemized deductions, is primarily used by low and moderate income taxpayers.[31] For example, 91% of 1994 individual returns with adjusted gross income between $10,000 and $20,000 used the standard deduction, but only 7% with adjusted gross income between $100,000 and $200,000 used it.[32] Therefore, the increased standard deduction for heads of households primarily benefits low

[28] The computations are based on the tax schedule for 1995. *See* Rev. Proc. 94-72, § 3.01, 1994-2 C.B. 811.

[29] Tax Reform Act of 1986, Pub. L. No. 99-514, § 102, 100 Stat. 2085, 2100.

[30] S. REP. No. 313, 99th Cong., 2d Sess. 36 (1986), *reprinted in* 1986-3 C.B. (Vol. 3) 1, 36; H.R. REP. No. 426, 99th Cong., 1st Sess. 88 (1985), *reprinted in* 1986-3 C.B. (Vol. 2) 1, 88.

[31] *See* Allan J. Samansky, *Nonstandard Thoughts About the Standard Deduction*, 1991 UTAH L. REV. 531, 549-50.

[32] STATISTICS, *supra* note 5, at 29 (Table 5).

and middle income persons. For 1995, the standard deduction is $5750 for a head of household, substantially above the $3900 to which an unmarried person who is not a head of household or qualifying surviving spouse is entitled.[33]

The third benefit of filing as head of household helps only high income taxpayers. The phaseout of personal exemptions, including those for the taxpayers themselves, begins when adjusted gross income is $143,350 for those filing as head of household in 1995.[34] In comparison, the phaseout begins at adjusted gross income of $114,700 for most other unmarried persons.[35] Therefore, filing as head of household may allow high income taxpayers to deduct a greater portion of the personal exemptions for themselves than they could if they were filing as unmarried persons who are not heads of household.

C. *Earned Income Credit*

The earned income tax credit is a refundable tax credit for low income persons.[36] Consequently, if the credit exceeds the regular tax liability, the individual will receive a net payment. The amount of the credit depends not only on adjusted gross income and earned income of the individual, but also on the number of children. Therefore, the credit is, in part, a wage or earned-income supplement for low income persons and, in part, a welfare-type transfer program in which the payment varies with the number of children. The amount is calculated by taking a fixed percent of earned income up to a stated maximum, and then phasing out the credit as adjusted gross income exceeds a threshold amount.[37] Table II shows how the credit varies according to income

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[33] Rev. Proc. 94-72, 1994-2 C.B. 811, 813. The standard deduction for married persons filing jointly is $6550 for 1995. *Id.*

[34] Rev. Proc. 94-72, 1994-2 C.B. 811, 814. *See* I.R.C. § 151(d)(3) (1994).

[35] Rev. Proc. 94-72, 1994-2 C.B. 811. *See* I.R.C. § 151(d)(3) (1994). Similarly the personal exemption is fully phased out when adjusted gross income is $265,850 for those filing as head of household and $237,200 for most other unmarried persons. Rev. Proc. 94-72, 1994-2 C.B. 811, 814. For married persons filing jointly, the phaseout begins when adjusted gross income is $172,050 and is fully phased out when adjusted gross income is $294,550. *Id.*

[36] *See* I.R.C. § 32 (1994). For a wide-ranging analysis and evaluation of the earned income tax credit, see Anne L. Alstott, *The Earned Income Tax Credit and the Limitations of Tax-Based Welfare Reform*, 108 HARV. L. REV. 533 (1995).

[37] For 1995, the credit percentage is 34% on a maximum of $6160 earned income for a qualifying taxpayer with one child, 36% on a maximum of $8640 earned income for a qualifying taxpayer with two or more children, and 7.65% on a maximum of $4100 earned income for a qualifying taxpayer with no children. Rev. Proc. 94-72, 1994-2 C.B. 811, 813. The credit is phased out at a rate of 15.98% starting at earned income or adjusted gross income of $11,290 for a taxpayer with one child, 20.22% starting at earned income

and the number of children.

TABLE II
THE EARNED INCOME CREDIT[38]

(1) Earned Income[39]	(2) EI Credit 0 Children	(3) EI Credit 1 Child	(4) EI Credit 2 Children	(5) Benefit from First Child (3)-(2)	(6) Benefit from Second Child (4)-(3)	(7) % Increase from Second Child (6)/(3)
$1,000	$76.50	$340.00	$360.00	$263.50	$20.00	5.88%
$2,000	$153.00	$680.00	$720.00	$527.00	$40.00	5.88%
$3,000	$229.50	$1,020.00	$1,080.00	$790.50	$60.00	5.88%
$4,000	$306.00	$1,360.00	$1,440.00	$1,054.00	$80.00	5.88%
$5,000	$313.65	$1,700.00	$1,800.00	$1,386.35	$100.00	5.88%
$6,000	$247.10	$2,040.00	$2,160.00	$1,792.91	$120.00	5.88%
$7,000	$170.60	$2,094.40	$2,520.00	$1,923.81	$425.60	20.32%
$8,000	$94.10	$2,094.40	$2,880.00	$2,000.31	$785.60	37.51%
$9,000	$17.60	$2,094.40	$3,110.40	$2,076.81	$1,016.00	48.51%
$10,000	$0.00	$2,094.40	$3,110.40	$2,094.40	$1,016.00	48.51%
$11,000	$0.00	$2,094.40	$3,110.40	$2,094.40	$1,016.00	48.51%
$12,000	$0.00	$1,980.94	$2,966.84	$1,980.94	$985.90	49.77%
$13,000	$0.00	$1,821.14	$2,764.64	$1,821.14	$943.50	51.81%
$14,000	$0.00	$1,661.34	$2,562.44	$1,661.34	$901.10	54.24%
$15,000	$0.00	$1,501.54	$2,360.24	$1,501.54	$858.70	57.19%
$16,000	$0.00	$1,341.74	$2,158.04	$1,341.74	$816.30	60.84%
$17,000	$0.00	$1,181.94	$1,955.84	$1,181.94	$773.90	65.48%
$18,000	$0.00	$1,022.14	$1,753.64	$1,022.14	$731.50	71.57%
$19,000	$0.00	$862.34	$1,551.44	$862.34	$689.10	79.91%
$20,000	$0.00	$702.54	$1,349.24	$702.54	$646.70	92.05%
$21,000	$0.00	$542.74	$1,147.04	$542.74	$604.30	111.34%
$22,000	$0.00	$382.94	$944.84	$382.94	$561.90	146.73%
$23,000	$0.00	$223.14	$742.64	$223.14	$519.50	232.81%
$24,000	$0.00	$63.34	$540.44	$63.34	$477.10	753.21%
$25,000	$0.00	$0.00	$338.24	$0.00	$338.24	n.a.
$26,000	$0.00	$0.00	$136.04	$0.00	$136.40	n.a.
$27,000	$0.00	$0.00	$0.00	$0.00	$0.00	n.a.

or adjusted gross income of $11,290 for a taxpayer with two or more children, and 7.65% starting at earned income or adjusted gross income of $5130 for a taxpayer with no children. *Id.*

[38] The computations are based on the tax schedule for 1995. *See* Rev. Proc. 94-72, §3.01, 1994-2 C.B. 811.

[39] It is assumed that earned income equals adjusted gross income.

As Table II illustrates, only a minimal credit is available for persons without children; the maximum credit is $314 in 1995. On the other hand, the credit is a substantial amount for a person with one child. It increases as earned income increases to a maximum of $2094 in 1995, which is available when earned income is at least $6160, but then decreases as earned income or adjusted gross income exceeds $11,290. The credit is fully phased out when adjusted gross income or earned income exceeds $24,396. For a person with at least two children, it is a maximum of $3110 for a person with earned income of at least $8640 but also decreases as adjusted gross income or earned income exceeds $11,290, and is fully phased out when adjusted gross income or earned income exceeds $26,673. Congress has not provided any rationale for the percentage amounts or other quantities that it has chosen for taxpayers with or without children,[40] nor has it explained why it decided to increase the credit for both the first and second children, but not to increase it for additional children.[41]

Table II reveals an interesting pattern for the increase in the amount of credit that is generated by a second child. At low incomes (earned income and adjusted gross income less than $7000), the second child adds a relatively small amount to the earned income credit. However, the extra benefit from the second child increases dramatically and becomes roughly a third of the entire credit when adjusted gross income and earned income are between $9000 and $15,000, and then becomes an even larger percentage of the entire amount as income increases above $15,000. The minimal benefit for very low income parents resulting from the second child is hard to explain. Why should a parent with earned income of $6000 receive an additional $1793 if she has one child, but only an additional $120 if she has a second child? Of course, this practice may be no more irrational than not providing any additional benefits if the

[40] It seems likely that the basic percentage of earned income for qualifying taxpayers without children, which is 7.65%, was deliberately established to equal the employee's portion of payroll taxes. *See* H.R. REP. NO. 111, 103d Cong., 1st Sess. 609 (1993), *reprinted in* 1993-3 C.B. 167, 185; Zelenak, *supra* note 1, at 401.

[41] It had apparently been planned for there to be a larger variation of the credit according to family size immediately prior to enactment of the Omnibus Budget Reconciliation Act of 1990. However, benefits for larger families may have been reduced "at the last moment" because of the way distribution tables for different income levels were constructed. Michael J. Graetz, *Paint-by-Numbers Tax Lawmaking*, 95 COLUM. L. REV. 609, 667–68. The distribution tables utilized tax filing units to illustrate the distribution of tax benefits and did not make adjustments for family size. Consequently, the tables overstated the ability to pay of larger families. Eugene Steuerle, *Are Children Mistreated by Tables on the Distribution of Income?*, 56 TAX NOTES 369 (1992); Zelenak, *supra* note 1, at 402.

parent has more than two children.

D. *Cumulative Impact*

Tables III and IV are intended to demonstrate the overall effect of children on tax liability. They illustrate the combined effect of the personal exemption for a dependent child, head of household status, and the earned income tax credit for representative taxpayers. Table III is for unmarried persons, and Table IV for married persons who file jointly.

TABLE III

UNMARRIED PERSONS[42]

	No Children		One Child			Two Children		
(1) AGI	(2) TI	(3) Tax Net of Credit	(4) TI	(5) Tax Net of Credit	(6) Savings from Child (3) - (5)	(7) TI	(8) Tax Net of Credit	(9) Savings from Second Child (5) - (8)
$2,500	$0	($191.25)	$0	($850.00)	$658.75	$0	($900.00)	$50.00
$5,000	$0	($313.65)	$0	($1,700.00)	$1,386.35	$0	($1,800.00)	$100.00
$7,500	$1,100	$32.66	$0	($2,094.40)	$2,127.06	$0	($2,700.00)	$605.60
$10,000	$3,600	$540.00	$0	($2,094.40)	$2,634.40	$0	($3,110.40)	$1,016.00
$15,000	$8,600	$1,290.00	$4,250	($864.04)	$2,154.04	$1,750	($2,097.74)	$1,233.70
$20,000	$13,500	$2,025.00	$9,250	$684.96	$1,340.04	$6,750	($336.74)	$1,021.70
$25,000	$17,500	$2,625.00	$14,250	$2,137.50	$487.50	$11,750	$1,424.26	$713.24
$30,000	$21,500	$3,225.00	$19,000	$2,850.00	$375.00	$16,500	$2,475.00	$375.00
$35,000	$25,500	$4,104.50	$23,000	$3,450.00	$654.50	$20,500	$3,075.00	$375.00
$40,000	$29,500	$5,224.50	$27,000	$4,050.00	$1,174.50	$24,500	$3,675.00	$375.00
$50,000	$37,500	$7,464.50	$35,000	$5,737.50	$1,727.00	$32,500	$5,037.50	$700.00
$75,000	$57,500	$13,093.00	$55,000	$11,337.50	$1,755.50	$52,500	$10,637.50	$700.00

42 The computations are based on the tax schedule for 1995. *See* Rev. Proc. 94-72, § 3.01, 1994-2 C.B. 811.

It is assumed that the itemized deductions are 20% of adjusted gross income before reduction under I.R.C. § 68 (1994). When adjusted gross income exceeds the "applicable amount," the itemized deductions are reduced by 3% of the excess of adjusted gross income over the applicable amount. *See* I.R.C. § 68 (1994).

TABLE III (cont'd)
UNMARRIED PERSONS[43]

	No Children		One Child			Two Children		
(1) AGI	(2) TI	(3) Tax Net of Credit	(4) TI	(5) Tax Net of Credit	(6) Savings from Child (3) - (5)	(7) TI	(8) Tax Net of Credit	(9) Savings from Second Child (5) - (8)
$100,000	$77,500	$19,293.00	$75,000	$16,937.50	$2,355.50	$72,500	$16,237.50	$700.00
$125,000	$98,059	$25,666.29	$95,309	$23,060.79	$2,605.50	$92,809	$22,285.79	$775.00
$150,000	$119,309	$32,321.74	$116,359	$29,586.29	$2,735.45	$114,009	$28,857.79	$728.50
$200,000	$161,809	$47,621.74	$159,859	$44,524.24	$3,097.50	$158,509	$44,038.24	$486.00
$250,000	$204,059	$62,831.74	$203,359	$60,184.24	$2,647.50	$203,009	$60,058.24	$126.00
$300,000	$245,559	$77,771.74	$245,559	$75,376.24	$2,395.50	$245,559	$75,376.24	$0.00
$400,000	$328,559	$110,245.86	$328,559	$107,850.36	$2,395.50	$328,559	$107,850.36	$0.00

43 The computations are based on the tax schedule for 1995. *See* Rev. Proc. 94-72, § 3.01, 1994-2 C.B. 811.

It is assumed that the itemized deductions are 20% of adjusted gross income before reduction under I.R.C. § 68 (1994). When adjusted gross income exceeds the "applicable amount," the itemized deductions are reduced by 3% of the excess of adjusted gross income over the applicable amount. *See* I.R.C. § 68 (1994).

Column 6 of Table III, which shows the tax benefits of a first child to an unmarried person, reveals two troublesome results. The first is the paltry benefits for those with adjusted gross incomes of $25,000 and $30,000 compared to those with higher and lower incomes. Their incomes are too high for the earned income tax credit and too low to benefit from the special rates for heads of households. The second is the substantial tax savings that high income persons continue to receive if they qualify as heads of households. An unmarried person with adjusted gross income of $300,000 saves $2395 in taxes as a result of supporting a child, a far more valuable benefit than a $2500 deduction.[44]

Column 9 of Table III, which shows the tax benefits of a second child to an unmarried person, also reveals some anomalies. At very low income levels, the benefits are quite small, but they quickly become substantial. However, after income becomes too high for the earned income credit, the only benefit is from the personal exemption, which is eventually phased out. Therefore, at adjusted gross income of at least $40,000, the benefits from the second child are much less than the benefits from the first.

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[44] At the highest marginal rate of 39.6%, a $2500 personal exemption would be worth only $990.

TABLE IV
MARRIED PERSONS FILING A JOINT RETURN[45]

	No Children		One Child			Two Children		
(1) AGI	(2) TI	(3) Tax Net of Credit	(4) TI	(5) Tax Net of Credit	(6) Savings from Child (3) - (5)	(7) TI	(8) Tax Net of Credit	(9) Savings from Second Child (5) - (8)
$2,500	$0	($191.25)	$0	($850.00)	$658.75	$0	($900.00)	$50.00
$5,000	$0	($313.65)	$0	($1,700.00)	$1,386.35	$0	($1,800.00)	$100.00
$7,500	$0	($132.35)	$0	($2,094.40)	$1,962.06	$0	($2,700.00)	$605.60
$10,000	$0	$0.00	$0	($2,094.40)	$2,094.40	$0	($3,110.40)	$1,016.00
$15,000	$3,450	$517.50	$950	($1,359.04)	$1,876.54	$0	($2,360.24)	$1,001.20
$20,000	$8,450	$1,267.50	$5,950	$189.96	$1,077.54	$3,450	($831.74)	$1,021.70
$25,000	$13,450	$2,017.50	$10,950	$1,642.50	$375.00	$8,450	$929.26	$713.24
$30,000	$18,450	$2,767.50	$15,950	$2,392.50	$375.00	$13,450	$2,017.50	$375.00
$35,000	$23,000	$3,450.00	$20,500	$3,075.00	$375.00	$18,000	$2,700.00	$375.00
$40,000	$27,000	$4,050.00	$24,500	$3,675.00	$375.00	$22,000	$3,300.00	$375.00
$50,000	$35,000	$5,250.00	$32,500	$4,875.00	$375.00	$30,000	$4,500.00	$375.00
$75,000	$55,000	$10,330.00	$52,500	$9,630.00	$700.00	$50,000	$8,930.00	$700.00
$100,000	$75,000	$15,930.00	$72,500	$15,230.00	$700.00	$70,000	$14,530.00	$700.00

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[45] The computations are based on the tax schedule for 1995. *See* Rev. Proc. 94-72, § 3.01, 1994-2 C.B. 811.

It is assumed that the itemized deductions are 20% of adjusted gross income before reduction under I.R.C. § 68 (1994). When adjusted gross income exceeds the "applicable amount," the itemized deductions are reduced by 3% of the excess of adjusted gross income over the applicable amount. *See* I.R.C. § 68 (1994).

TABLE IV (cont'd)

MARRIED PERSONS FILING A JOINT RETURN[46]

	No Children		One Child			Two Children		
(1) AGI	(2) TI	(3) Tax Net of Credit	(4) TI	(5) Tax Net of Credit	(6) Savings from Child (3) - (5)	(7) TI	(8) Tax Net of Credit	(9) Savings from Second Child (5) - (8)
$125,000	$95,309	$21,648.29	$92,809	$20,916.52	$731.77	$90,309	$20,216.52	$700.00
$150,000	$116,059	$28,080.79	$113,559	$27,305.79	$775.00	$111,059	$26,530.79	$775.00
$200,000	$158,759	$42,075.74	$156,859	$41,391.74	$684.00	$154,959	$40,707.74	$684.00
$250,000	$202,259	$57,735.74	$201,359	$57,411.74	$324.00	$200,459	$57,087.74	$324.00
$300,000	$245,559	$73,323.74	$245,559	$73,323.74	$0.00	$245,559	$73,323.74	$0.00
$400,000	$328,559	$105,797.86	$328,559	$105,797.86	$0.00	$328,559	$105,797.86	$0.00

46 The computations are based on the tax schedule for 1995. *See* Rev. Proc. 94-72, § 3.01, 1994-2 C.B. 811.

It is assumed that the itemized deductions are 20% of adjusted gross income before reduction under I.R.C. § 68 (1994). When adjusted gross income exceeds the "applicable amount," the itemized deductions are reduced by 3% of the excess of adjusted gross income over the applicable amount. *See* I.R.C. § 68 (1994).

It is interesting to compare Table IV, which shows the tax benefits of children for married couples, to Table III. At low incomes the tax benefit of children to married persons filing jointly is very close to that of unmarried parents. In fact, at very low incomes, when there is no income tax liability, the benefits are identical because they come solely from the earned income tax credit, which does not distinguish between married and unmarried persons. The big difference between the benefits for married and unmarried persons arises from the big tax savings to relatively high income unmarried persons who use the head of household schedule. Married persons have no comparable benefit. However, it should be kept in mind that married couples are still paying substantially less tax than unmarried parents with the same income and number of children.

II. TRADITIONAL PROPOSALS

This section discusses the various proposals that have been suggested for determining the effect of children on ability to pay. The proposals include a deduction for subsistence cost of a child, a deduction for estimated costs of raising a child, income splitting between parents and children, and a tax credit for part or all of the expected cost of a child. The discussion demonstrates that none of the proposals provides a satisfactory approach for systematically determining the effect of children on ability to pay.

A. *Deduction for Subsistence Cost*

Many have argued that all parents should be allowed a deduction for the cost of supporting a child at subsistence. The contention is that only income in excess of what is required for subsistence is available for discretionary spending, and thus only that amount should be taken account of when determining ability to pay.[47] The $2500 personal exemption allowed as a deduction for a dependent child is generally consistent with this approach,[48]

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[47] For a forceful statement and defense of this argument, see Zelenak, *supra* note 1, at 361-65. *See also* HAROLD M. GROVES, FEDERAL TAX TREATMENT OF THE FAMILY 10 (1963); Gerard M. Brannon & Elliott R. Morss, *The Tax Allowance for Dependents: Deductions Versus Credits*, 26 NAT'L TAX J. 599, 602–04 (1973).

For the position that the personal exemption should be "thought of as a device by which the community shares or subsidizes the subsistence costs of children," see Thomas F. Pogue, *Deductions vs. Credits: A Comment*, 27 NAT'L TAX J. 659, 659 (1974). According to this perspective, tax credits would be more equitable than tax deductions.

[48] According to the official poverty guidelines, a child adds $2560 to the poverty threshold for a family. Annual Update of HHS Poverty Guidelines, 60 Fed. Reg. 7772

although many of its supporters probably would prefer a higher amount.[49] However, the phaseout of the exemption for high income persons would not be justified[50] because, it is argued, subsistence costs reduce the ability to pay even for the most affluent.[51]

Unless the most poor and destitute are to be subject to income tax, it is necessary to determine some level of economic well-being below which persons will not be subject to tax. Congress apparently has selected the official poverty guideline as the appropriate threshold, and that seems to be a reasonable choice.[52] Consequently, most persons are allowed a deduction of what the poverty guidelines indicate is required for subsistence.

On the other hand, there is no reason to import the poverty guidelines and the related concept of subsistence income into equitable taxation of affluent parents. In the United States, cost of subsistence is clearly not a measure of the minimum cost for physical survival. A minimally adequate standard of living is to a large extent based on cultural and social factors. Determinations of what is necessary for a barely adequate lifestyle are necessarily subject to dispute, and it is not clear that there is a national consensus on what is needed for subsistence.[53] Since cost of subsistence is necessarily somewhat subjective, income above subsistence must also be subjective.[54]

Furthermore, the concept of income above subsistence probably has no meaning to most affluent persons since they do not relate their economic well-being to some concept of discretionary income. A person with $80,000 income who receives a raise of $20,000 thinks that her income has increased 25%, not

(1995) [hereinafter Poverty Guidelines]. For discussion of these guidelines, see *infra* notes 128–34 and accompanying text.

[49] *See* Zelenak, *supra* note 1, at 382.

[50] For discussion of the phaseout, see *supra* notes 11–14 and accompanying text.

[51] *See* Zelenak, *supra* note 1, at 366–69.

[52] *See infra* notes 127–30 and accompanying text.

[53] In the 1960s the creators of the official poverty guidelines for the United States sidestepped these problems by multiplying the cost of food by three to obtain the poverty thresholds, but this method merely hid all the assumptions and problems. PATRICIA RUGGLES, DRAWING THE LINE: ALTERNATIVE POVERTY MEASURES AND THEIR IMPLICATIONS FOR PUBLIC POLICY 4 (1990). As Ruggles, an expert in the measurement of poverty, has noted, the official poverty measure that the federal government uses "became the 'official' standard of the federal government through a haphazard process of use rather than through any systematic approach." *Id.* at 3. Since 1969 the poverty threshold has simply been indexed for inflation by the Consumer Price Index. For discussion of the official poverty guidelines, see *infra* notes 128–34 and accompanying text.

[54] "The notion of [discretionary income], unfortunately, is so subjective as to be impossible to delineate with the precision necessary for it to be useful in fashioning an operating tax system." McIntyre & Oldman, *supra* note 23, at 1603.

that her income above subsistence has increased by some larger percentage. There is no reason that tax liability should be determined according to a concept that is irrelevant to taxpayers.

Neither cost of subsistence nor income in excess of subsistence has significance when comparisons are made of affluent persons' welfare or their control over income. What members of affluent households perceive as necessary or appropriate for food, shelter, and clothing is completely different from (and much more expensive than) what is necessary for subsistence by any definition. For example, a decision that a maximum of two, rather than three, siblings should have to share the same bedroom in setting the poverty guidelines should not affect the tax liability of an affluent family with three children. Whatever the poverty guidelines, children in affluent families will usually have separate bedrooms; any change in the poverty guidelines is irrelevant to these families. For another example, assume that the cost of inexpensive clothing made of synthetic materials has increased significantly and thus the cost of subsistence has also increased, but that the cost of the more expensive wool and cotton clothing that appeals to affluent families has not increased at all. This divergence of prices may be unlikely, but is clearly not impossible. The increased cost of inexpensive clothing has not caused the ability to pay of an affluent household with children to decrease relative to that of an affluent household without children. The prices of the goods that these two households purchase and consume has, by assumption, not changed at all, and their relative tax liabilities should not change.

Parents are legally required to support their children, and it might be argued that this legal obligation justifies a deduction for subsistence cost. The reasoning would be that parents are generally required to spend at least that amount on their children. However, for the overwhelming number of parents, this legal requirement has no significance. Parents would support and provide for children without any legal requirements.[55] The obligations imposed by societal and family norms are the salient considerations for most parents, and these obligations often require expenditures much greater than the cost of subsistence. The legal requirements are usually of no significance and should not be a factor in determining ability to pay.

The personal exemptions that are generally allowed every adult who files a return are not subject to the same criticism as personal exemptions for children. The former gives everybody a similar tax benefit, and as noted in this context,

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[55] The one exception that readily comes to mind is support obligations of a noncustodial, divorced parent. Because the tax consequences in this situation involve the more general issue of tax treatment of alimony and child support following divorce or separation, they are beyond the scope of this Article.

"a concession to everybody is a concession to nobody."[56] If every person filing a return is allowed a deduction, then the effect of the deduction for high income persons can be counteracted, to whatever extent desired, by changes in marginal rates.[57] Because personal exemptions for children differentiate among families of different sizes, they cannot be completely neutralized by increases in marginal rates.

B. *Deduction for "Costs" of Raising Child*

A second proposal is that parents be allowed a deduction for what they spend on their children.[58] Certainly, parents spend significant amounts on a child's food, clothing, and other needs, and thus shift resources to a child's consumption that otherwise would probably be used for themselves. It appears reasonable to argue that the amounts spent on the child reduce the parent's ability to pay tax.[59] According to this rationale the amount spent on a child by a particular family, or more likely the average amount spent on a child by similarly situated families, should be deductible.[60]

A deduction for the amount expended on a child can be thought of as a deduction for the cost of raising that child, but the term "cost" must be carefully used. A parent has a great deal of discretion over how much to spend on her child, choosing some point between the minimum amount needed for the child's subsistence and 100% of available resources. Consequently, the cost of

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[56] GROVES, *supra* note 47, at 29. *See also* SELTZER, *supra* note 9, at 6; *Dependency Exemptions*, *supra* note 1, at 869.

[57] Increases in marginal rates can be thought of as having the incidental effect of taking away the benefit of the personal exemption for high income persons. *See* I.R.C. § 11(a)(1) (1994) (increase in marginal rates for corporations with taxable incomes in excess of $100,000 limited to tax saved by low rates on taxable income below $75,000).

[58] Professor Bittker suggested and seemed to support such a proposal. *See* Bittker, *supra* note 24, at 1450–51.

[59] A related issue is whether the amounts deemed spent on children's consumption should be attributed to the children for tax purposes and subject to tax on that basis. Income splitting between parents and children is discussed in the next subsection.

[60] A related proposal is that parents be allowed a deduction for some portion of what they spend on children, but there needs to be a reasoned argument for specifying a particular portion. An arbitrary percentage of total costs does not meet that criterion. Similarly, a deduction only for necessities (food, shelter, and clothing) for the child is not satisfactory. Any line between necessities and luxuries does not exist if the "necessities" exceed what is needed for subsistence. Discretionary spending on clothing or food is not conceptually different from discretionary spending on entertainment. Finally, a deduction for a particular portion of costs would be subject to the same critique to which a deduction for the entire cost is subjected. For discussion of this criticism, see *infra* notes 61–65 and accompanying text.

a child is, to a large extent, determined by the parents' income, values, and preferences. Not surprisingly, parents tend to spend more on their children as their income increases. In fact, the reported estimates indicate that there is only a slight variation among high- and low-budget families of the same size and composition in the *proportion* of family expenditures spent on children.[61] Although low-budget families may tend to spend a somewhat larger percentage on children, high-budget families clearly tend to spend more in total dollars on their children when comparing otherwise similar families. Consequently, a deduction for what parents spend on children would imply a deduction that increases as income increases. Several persons have proposed such a deduction, although not always specifying what guidelines or principles should be used for determining the amount of the deduction.[62]

The recognition that "cost" of a child is not a fixed amount reveals a basic weakness in the argument that a deduction for the child's cost should be allowed. A deduction should not be allowed for voluntary expenditures used for consumption.[63] Furthermore, a deduction for the cost of a child based on pre-tax income ignores the fact that the amount spent on the child will probably be adjusted because of the tax liability. The result will likely be that the amount spent on the child will be less than the deduction and the difference will be shifted to consumption by the parent. The consequence is that the parent will be undertaxed relative to an adult without children. An example illustrates this problem.

Consider two families: Family A with two adults, one child, and income of $120,000; and Family B with only two adults and income of $100,000. Tax liability equals 25% of taxable income; a deduction for the expected cost of a child, but no other personal exemptions, is allowed. Assume that the average family spends equal amounts on each of the adults and 40% as much on the child as on an adult.[64] Thus Family A would be expected to spend $50,000 on

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[61] OFFICE OF THE ASSISTANT SECRETARY FOR PLANNING AND EVALUATION, U.S. DEP'T. OF HEALTH AND HUMAN SERVICES, ESTIMATES OF EXPENDITURES ON CHILDREN AND CHILD SUPPORT GUIDELINES 4-8 (October 1990) [hereinafter EXPENDITURES].

[62] For example, the author of a background paper for a conference on taxation and the family that was sponsored by the Brookings Institution seemed to endorse (at least for moderate income families) a deduction equal to a percentage of income, but did not indicate what percentage should be used. GROVES, *supra* note 47, at 34. *See also* A.C. PIGOU, A STUDY IN PUBLIC FINANCE 101-03 (1928); SELTZER, *supra* note 9, at 103, 108; Bittker, *supra* note 24, at 1450-51.

[63] There are also practical problems in estimating the cost of a child. Making estimates of how much typical or average families spend on their children is very difficult and must be based on simplifying assumptions. For discussion of some studies that attempt to determine the cost of a child, see *infra* Part II.C.3.

[64] It has been estimated that the average family spends 40% as much on a child as on

each adult and $20,000 on the child from its pre-tax income and Family B, $50,000 on each adult. We can conclude that the adults in the two families are equally well off before tax, and thus they should be equally well off after tax.

If we allow Family A a deduction of $20,000 for the cost of the child, the family's taxable income becomes $100,000, and they owe $25,000 of tax. Family A retains $95,000 after paying its tax liability (the original income of $120,000 minus $25,000 tax payment) and would be expected to spend $39,583 on each adult and $15,833 (.4 x $39,583) on the child, thereby spending the entire $95,000. On the other hand, Family B retains $75,000 after paying its tax liability and can spend only $37,500 on each adult. Clearly, Family B is being taxed more heavily than Family A.

In fact, Family A would be taxed equally to Family B if there were no deduction for a child at all. Family A would then pay $30,000 in tax (25% of $120,000), leaving $90,000 after tax. They could then spend $37,500 on each adult and $15,000 on the child (40% of $37,500) and the adults would be equally well off as those in Family B.[65] The basic problem is that the amount spent on the child in Family A should be subject to tax, even if the parents are allowed a deduction for the child's consumption. Because the child is consuming a portion of income, that amount should be taxed to the child. Therefore, income splitting between parent and child, rather than simply a deduction for the parents, needs to be examined.

C. *Income Splitting*

1. *General Considerations*

A third method that has been suggested for taking account of the effect of children on tax liability is splitting income among family members.[66] Proponents usually do not contemplate that the tax liability actually be owed by the children, but rather that the amount of the tax liability (probably to be paid

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an adult. EDWARD P. LAZEAR & ROBERT T. MICHAEL, ALLOCATION OF INCOME WITHIN THE HOUSEHOLD 193 (1988). The example assumes all income is being spent.

[65] This conclusion is a consequence of a proportional tax (25% of taxable income) and the absence of personal exemptions for the adults. If marginal rates increased as income increased, then Family A would need a deduction to be taxed equally to Family B. One could also get the correct result by attributing the appropriate amount of family income to the child and taxing the child proportionately to the adults, assuming the child's welfare is equal to that of an adult when it has 40% of an adult's income. *See infra* notes 80–84 and accompanying text.

[66] *See* WILLIAM VICKREY, AGENDA FOR PROGRESSIVE TAXATION, 295–96 (1947); McIntyre & Oldman, *supra* note 23, at 1599–1607; Zelenak, *supra* note 1, at 373–79.

by the parents) be determined according to this approach.[67]

The rationale for income splitting is that, for tax purposes, income should be attributed to the person who benefits from it. Accordingly, the appropriate amount of household income would be attributed to each child, and tax liability determined according to separate rate schedules for each individual in the household. Income splitting can be viewed as an extension of the proposal that a deduction for the amount expended on children be allowed to the parents. With income splitting, the actual or estimated amount spent on children would be deducted from the parent's income and become part of the children's income, rather than be completely removed from the tax base. The major theoretical objection to a deduction for the cost of a child, that discretionary amounts spent on consumption completely escape tax, is not an issue with income splitting.

With appropriate assumptions, there appears to be a strong theoretical case for income splitting.[68] Problems with income splitting, however, become apparent when one considers the practical decisions necessary to implement it. The remainder of this section explores the implications and weaknesses of income splitting.

Any evaluation of income splitting among family members has to take into account that it does not necessarily lead to any tax savings for families. If there were a proportional income tax and (as would be expected) the same rate for adults and children,[69] total tax liability would be unchanged regardless of how

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67 McIntyre & Oldman, *supra* note 23, at 1599–1600; Zelenak, *supra* note 1, at 377 n.121.

68 An underlying assumption of income splitting is that income should, for tax purposes, be attributed to the person who directly benefits from it. In my opinion, this assumption is appropriate because it is consistent with progressive tax rates. As income attributed to a particular person increases, we infer that less critical needs are being met and consequently that it is appropriate to tax the additional income at a higher rate. *See infra* note 149 and accompanying text. *See also* McIntyre & Oldman, *supra* note 23, at 1576–77. For the view that control rather than benefit should be the determining factor for taxation, see Zelenak, *supra* note 1, at 372–73. *See also* Neil Brooks, Comment, *in* TAXATION TO 2000 AND BEYOND, 200, 206–07 (Richard M. Bird & Jack M. Mintz eds. 1992); Lawrence Zelenak, *Marriage and the Income Tax*, 67 S. CAL. L. REV. 339, 354–58 (1994).

An additional assumption of income splitting in a family is that there is a clear demarcation between consumption by the parents and by the children. The discussion in *infra* Part III challenges this assumption for affluent parents both because the decision to have children can usually be seen as voluntary and because the children provide direct and indirect satisfaction to the parents.

69 With the reasonable assumption that a child's economic needs are generally less than those of an adult, there is no justification for taxing income attributable to a child at a lower rate than that used for adults. And taxing the income attributable to a child at a higher rate

income were allocated among family members.[70] Thus, if tax liability were 10% of taxable income, the tax liability for a household with $100,000 income would be $10,000 whether the $100,000 were all attributed to one adult, all attributed to a child, or split in any way between the two.[71] Although the federal income tax is progressive, with rates increasing from 15% to 39.6% as income increases, most individual returns are subject only to the 15% rate.[72] For these persons, income splitting with children would provide absolutely no tax benefit. There may be a benefit from the personal exemption, but personal exemptions for children can be allowed with or without income splitting.[73]

On the other hand, income splitting with children would result in tax savings for affluent taxpayers who are subject to high marginal rates. These persons would benefit if their income, which would otherwise be taxed to them, were attributed to their children and then taxed (at least in part) at relatively low rates. In general, the higher the income of the parent, the greater is the tax saving from income splitting.[74] For example, in 1995 a married couple filing jointly would benefit from income splitting only if its *taxable income* exceeded $39,000.[75] Under reasonable assumptions about itemized deductions, the couple's *adjusted gross income* would then exceed $60,000.[76]

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would be unacceptable because a household with one or more children might then owe more tax than an otherwise similar household with no children.

70 Recall that we are concerned only with the total amount of household tax liability, not with which members of the household will actually owe the tax. *See supra* note 67 and accompanying text.

71 I am assuming that the deductibility of a personal exemption for the child is not affected by whether any income is attributed to the child. As current law illustrates, a parent can be allowed a deduction for a child without attributing any income to the child.

72 DEPARTMENT OF THE TREASURY, INTERNAL REVENUE SERVICE, PUB. NO. 1304, INDIVIDUAL INCOME TAX RETURNS 1992 95 (Table 3.4) (1995) [hereinafter INDIVIDUAL INCOME TAX RETURNS].

73 It is possible to view a personal exemption for a child as a limited form of income splitting. The amount of the personal exemption is attributed to a child and taxed at zero rate. *See* Brannon & Morss, *supra* note 47, at 604; McIntyre & Oldman, *supra* note 23, at 1607.

74 The proportion of income allocable to children could decrease as income increases. Obviously, with less income being attributed to a child, tax savings from income splitting would diminish from what it would be if the proportion stayed the same. However, the absolute amount being allocated to a child should never decrease as income increases, and therefore tax savings from the income splitting should never decrease. It is being assumed that the marginal rate of the child will not be higher than that of the parent.

75 The lowest bracket of 15% ends, and the next bracket of 28% begins, at $39,000. *See* Rev. Proc. 94-72, 1994-2 C.B. 811.

76 With four personal exemptions of $2500 each and itemized deductions equal to 20% of adjusted gross income, adjusted gross income of $61,250 results in taxable income

The amount of tax saving, of course, would depend on the sharing formula. For illustrative purposes, Table V shows the saving when 25% of income is attributed to the children,[77] which may be a reasonable assumption.[78] The benefit increases fairly quickly as income rises above $60,000, totaling $910 for a person with adjusted gross income of $70,000, $1673 for adjusted gross income of $80,000, and a maximum saving of $8023. Of course, different formulas for splitting income, possibly including an upper limit on the amount taxed to children, would give different results.

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of $39,000.

[77] The schedule used for the parents, a married couple filing jointly, is also used for the children, although with brackets adjusted to reflect the reduced needs of children. *See infra* notes 83–84 and accompanying text (explaining adjustment of brackets). It may appear more appropriate to use the schedule for unmarried persons for the income attributable to the children. With this schedule for the children, however, income splitting may increase the tax liability of families with children. Obviously, this result is contrary to the intent of income splitting.

[78] FAM. ECON. RES. GROUP, AGRIC. RES. SERV., U.S. DEP'T OF AGRIC., EXPENDITURES ON A CHILD BY FAMILIES, 16 (Table A) (1993) [hereinafter EXPENDITURES ON A CHILD BY FAMILIES]. Calculations from this study indicate that the average annual expenditures on the children in a two-adult, two-child family with average income $79,400 (in 1993 prices) are 27% of pre-tax income. The study probably overestimates the amount being expended on children. *See infra* text accompanying note 104.

TABLE V[79]
TAX SAVINGS FROM INCOME SPLITTING

(1) AGI	(2) TI with 2 Children	(3) Tax	(4) Tax with Income Splitting	(5) Savings from Splitting (3) - (4)
$40,000	$22,000	$3,300.00	$3,300.00	$0.00
$50,000	$30,000	$4,500.00	$4,500.00	$0.00
$60,000	$38,000	$5,700.00	$5,700.00	$0.00
$70,000	$46,000	$7,810.00	$6,900.00	$910.00
$80,000	$54,000	$10,050.00	$8,376.90	$1,673.10
$90,000	$62,000	$12,290.00	$10,616.90	$1,673.10
$100,000	$70,000	$14,530.00	$12,856.90	$1,673.10
$125,000	$90,309	$20,216.62	$18,543.42	$1,673.10
$150,000	$111,059	$26,530.79	$24,353.42	$2,177.37
$200,000	$154,759	$40,635.74	$37,471.62	$3,164.13
$300,000	$245,559	$73,323.74	$68,348.17	$4,975.58
$400,000	$328,559	$105,797.86	$98,228.17	$7,569.70
$500,000	$411,559	$138,665.86	$130,643.07	$8,022.79
$1,000,000	$826.559	$303,005.86	$294,983.07	$8,022.79

This pattern of tax saving does not rebut any argument that income splitting among children is the conceptually right approach, but its advocates would have to be comfortable with little or no tax saving for moderate income persons and large tax savings for the affluent.

2. *Mechanism*

There are two steps for implementing tax splitting with children: (1) determining the portion of family income to be attributed to a child, and (2) deciding how the tax schedule for the child should compare to that for an adult. Each step poses difficulties.

No one advocates determining what each family actually spends on the children and attributing that amount of income to them for tax purposes. Among other problems, making a family keep track of expenditures to the extent necessary would impose an intolerable and perhaps impossible burden.

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[79] The computations are based on the tax schedule for 1995. *See* Rev. Proc. 94-72, § 3.01, 1994-2 C.B. 811.

It is assumed that itemized deductions are 20% of adjusted gross income before reduction under I.R.C. § 68 (1994). When adjusted gross income exceeds the "applicable amount," the itemized deductions are reduced by 3% of the excess of adjusted gross income over the applicable amount. *See* I.R.C. § 68 (1994).

Instead, we would presumably estimate what a "typical" family might spend, taking account of the family's income, number of children and adults, and possibly other factors. Making estimates of how much typical or average families spend on their children, however, is very difficult and must be based on simplifying assumptions. Even a sophisticated study cannot just observe a sample of families and determine expenditures on each member. It is estimated that 90% of a family's expenditures are made either on shared goods (such as housing) or privately consumed goods (such as food) that are not easily attributed to a single member.[80] Simply allocating income per capita among adults and children is also not acceptable.[81] Although their needs vary by age, most children are smaller than adults and require less economic resources for support. In addition, we would usually expect the marginal (or additional) cost of a new family member to be less than the average cost. For example, a first child in a two-adult family should not require 50% increases in the cost of shelter or transportation. Consequently, detailed data alone will not allow us to attribute consumption of these goods among the appropriate members.

Social scientists have attempted to measure expenditures on children indirectly. They first draw conclusions about a family's economic welfare, relative to other families, by observing certain data. They then find income levels at which various size families have the same economic well-being and compute the differences. For example, if a two-adult household with $40,000 income and no children had the same economic well-being as a two-adult household with $50,000 income and two children, then the second family needs $10,000 additional income to achieve the same standard of living as the first family. We can conclude that the second family spends $40,000 on the adults and $10,000 on the children. In fact, there is no single, accepted method of comparing economic well-being of households of different sizes (or of individuals in different size households), but the attempts to do so are instructive and are summarized below in the next subsection.

One general observation, however, is appropriate. With income splitting, the amount of income taxed to parents and children respectively will necessarily be the wrong amount by a substantial margin for many, and perhaps most, families. There are several reasons for this. First, the studies of how much average families spend on children necessarily rely on simplifying assumptions and thus may not be accurate. In fact, the studies give us

[80] *See* EXPENDITURES, *supra* note 61, at 2-3 to 2-5 (reporting result from DAVID M. BETSON, U.S. DEP'T OF HEALTH AND HUMAN SERVICES, ALTERNATIVE ESTIMATES OF THE COST OF CHILDREN FROM THE 1980-1986 CONSUMER EXPENDITURE SURVEY (September 1990)).

[81] *See* EXPENDITURES, *supra* note 61, at 2-6; LAZEAR & MICHAEL, *supra* note 64, at 192.

substantially different results. Second, income splitting affects only quite affluent taxpayers, and it is not clear that the results from these studies are applicable to them. Third, even if the estimates were accurate, they only indicate what a typical family does. Expenditures on children vary a great deal even among families of the same size and income.[82] Although not fatal by itself, the impossibility of taxing the appropriate amount of income to children may diminish the appeal of income splitting.

The second necessary step of income splitting, determining the appropriate income schedule for a child, may also present problems. With a progressive tax, increased income is presumably taxed at higher rates because it satisfies less critical needs. Furthermore, a child's economic needs would be expected to be much less than those of an adult. Therefore, if $20,000 of family income is attributed to a child for tax purposes, we would expect the child's tax liability to be greater than that of an adult with $20,000 income. With progressive tax rates, it would be inappropriate to use the same tax schedule for the child as for an adult.[83]

The goal would be for the child and adult with the same economic capacity to make an equal sacrifice. In this event their after-tax economic capacity would also be the same. The usual procedure assumes that the ratio of sharing between child and adult in a family indicates relative expenditures at which they are equally well off. Thus, if expenditures on a child are 40% of those on an adult, a child is presumed to be equally well off as an adult when the child has 40% as much income as the adult. With this reasoning, if a child's before-tax income is 40% of an adult's before-tax income, the child's after-tax income should also be 40% of the adult's after-tax income. The child and adult would then have equal after-tax capacity.[84]

This assumption that the sharing of resources in a family indicates equal levels of economic well-being may be questioned. It is the parent who is deciding how the money is being spent. The proportion of income spent on the child may tell us more about the parent's needs and perceptions than about the child's welfare. On the other hand, there does not seem to be any other satisfactory way of comparing welfare of children to that of adults. Children are not merely miniature adults. At least when young, they are totally dependent on their parents and, after subsistence needs have been met, do not

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[82] *See* EXPENDITURES, *supra* note 61, at 4-23 to 4-24; LAZEAR & MICHAEL, *supra* note 64, at 27.

[83] *See* Zelenak, *supra* note 1, at 376. *But see* McIntyre & Oldman, *supra* note 23, at 1605–07 (assumes would be same schedule).

[84] VICKREY, *supra* note 66, at 295–96; *see* Zelenak, *supra* note 1, at 376–77. To obtain this result, one would divide the child's income by .4, compute tax using the adult's rate schedule, and then multiply this amount by .4. For similar computations, see *id.*

have economic demands comparable to those of adults.

3. *Empirical Results*

In order to determine the effect of children on ability to pay, we need to compare "economic well-being" of different-sized families (or of the individuals in these families).[85] Of course, economic well-being cannot be directly measured in this situation, and thus some indirect method must be used. A popular method evaluates the economic well-being of a household by examining the proportion of food expenditures to either household income or total expenditures.[86] Scholars have noted that (holding family size constant) poor families tend to devote a higher proportion of their total consumption to food than do rich families and that (holding income constant) larger families tend to devote a higher proportion of their consumption to food than do smaller families.[87] Consequently, it can be hypothesized that households of various sizes would have equal economic capacity if the proportion of expenditures or income spent on food is equivalent. This method is often called the "Engel estimator" after Ernst Engel who developed it in the mid-1800s.[88] Using this approach, a recent study determined that two-adult families with one child can expect to commit about 30% of total family expenditures to their child; with two children the proportion increases to between 40 and 45%; and with three children it is nearly 50%.[89] If this is correct, on average almost as much is

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[85] *See supra* notes 80–82 and accompanying text.

[86] *See* THOMAS J. ESPENSHADE, INVESTING IN CHILDREN: NEW ESTIMATES OF PARENTAL EXPENDITURES (1984); Joseph J. Seneca & Michael K. Taussig, *Family Equivalence Scales and Personal Income Tax Exemptions for Children*, 53 REV. ECON. & STAT. 253 (1973). Thomas Espenshade examined a number of items that might be used in a similar fashion to compare economic well-being of households of different sizes including total food, food consumed at home, food consumed away from home, housing, clothing, transportation, and some combinations of these items. He determined that the proportion of food consumed at home was most suitable for evaluating economic well-being. ESPENSHADE, *supra*, at 89–98. Joseph Seneca and Michael Taussig also experimented with various commodities as necessities that could be used to compare welfare of different sized families. Seneca & Taussig, *supra*, at 256.

[87] *See* EXPENDITURES, *supra* note 61, at 2-13, 2-14; Boone A. Turchi, *Estimating the Cost of Children in the United States*, Final Report to the National Institute of Child Health and Human Development, 8–10 (1983). *See also* ESPENSHADE, *supra* note 86, at 87–89 (1984).

[88] *See* EXPENDITURES, *supra* note 61, at 2–13 (citing ERNST ENGEL, "DIE PRODUCTIONS UND CONSUMTIONSVERHALTNISSE DES KONIGSREIHS SACHSEN," ZEITSCRIFT DES STATISTICSHEN BUREAUS DES KONIGLICH SACHISCHEN MINISTERIUMS DES INNERN 3 (1857)).

[89] ESPENSHADE, *supra* note 86, at 3.

being spent on a child as on an adult in both one and two-child families.[90]

The Engel estimator may, however, overestimate the cost of children because it assumes that the proportion of all expenditures devoted to food is the same for both children and adults. It has been suggested that children are probably "food intensive"; they consume a larger proportion of food relative to other goods than do adults.[91] If this hypothesis is true, the family with children skews its consumption more to food than the family without children (even if their tastes are otherwise similar). Therefore, if the family with children spends the same proportion of its budget on food as the family without children, the family with children is economically better off. The Engel estimator would use the total difference in expenditures between these two families to measure the cost of children, but that amount overstates the "real" cost.

Another method of determining the effect of children on a household's economic well-being examines certain expenditures that can only benefit adults. The amount of these expenditures can then be used as an equivalency measure. Households with the same number of adults that spend the same absolute amount on these adult goods can be assumed to be equally well off and thus have equal ability to pay tax. This method is often called the "Rothbarth estimator" after Erwin Rothbarth who first proposed it in the 1940s.[92] A key difference between the Rothbarth and Engel estimators is that the former measures welfare of adults by looking at their consumption of adult goods while the latter attempts to measure welfare of the entire family by looking at the proportion of the household budget devoted to food. Consequently, the two criteria should not be expected to give identical measures of family equivalence.[93]

The Rothbarth method was used in a study by Edward P. Lazear and Robert T. Michael, who used expenditures on adult clothing, alcohol, and tobacco as the observable adult expenditures.[94] Their basic assumption was that the relationship between expenditures on these items and expenditures on other items benefiting adults is not affected by the presence or number of children. Thus, comparisons between families with different numbers of children could

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[90] If 30% of expenditures in a two-adult, one-child family are spent on the child, an average of 35% is being spent on each of the adults. If 45% of expenditures in a two-adult, two-child family are being spent on the two children, 55% is being spent on the two adults.

[91] *See* EXPENDITURES, *supra* note 61, at 2-28 to 2-29.

[92] *See* EXPENDITURES, *supra* note 61, at 2-16 (citing Erwin Rothbarth, *Notes on a Method of Determining Equivalent Income for Families of Different Composition*, *in* WAR-TIME PATTERN OF SPENDING AND SAVING (Charles Madge ed., app. 4, 1943)).

[93] For discussion and comparison of the two methods, see EXPENDITURES ON A CHILD BY FAMILIES, *supra* note 78, at 12–13 (1993); Turchi, *supra* note 87, at 10–13.

[94] *See* LAZEAR & MICHAEL, *supra* note 64.

be made from these observable expenditures.[95] Most of their analysis concerned the allocation of goods among members of a family, and they cautioned that their method did not justify a comparison of economic well-being among families with different numbers of children.[96] However, they did estimate that an average family spends about 40% as much on a child as it spends on an adult.[97] The implication is that a two-adult, two-child household would devote about 14.5% of expenditures to each child.[98]

It has been suggested that the Rothbarth estimator will underestimate the cost of children because a household with children will substitute from goods that must be shared with children to goods that will only benefit adults.[99] If this assumption is correct, the two-adult family with children is economically worse off than a two-adult family without children that devotes the same total amount to adult goods. According to the Rothbarth estimator, however, the two families are considered to have the same economic welfare, and their difference in expenditures is the deemed cost of the children. Since the first family is actually worse off than the second, the difference in expenditures understates the cost of children.

A study sponsored by the Department of Agriculture makes estimates on the cost of children without making questionable assumptions about economic welfare, but its conclusions are also subject to doubt.[100] Using data from the 1990 Consumer Expenditure Survey, the study determined how household expenditures on various budgetary components are affected by the number of children and income.[101] It then estimated how much money various types of

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[95] More precisely, the ratio between the observed adult expenditures and total adult expenditures could be determined for families without children. Observed adult expenditures can then be obtained for families with children, and the impact of children on the amount of such expenditures statistically estimated. Finally, the impact of children on total adult expenditures can be derived from the formula between observed and total adult goods obtained from the families without children.

[96] LAZEAR & MICHAEL, *supra* note 64, at 193.

[97] *Id.*

[98] To obtain this amount, let A be the total expenditures on one adult; then .4*A is the total expenditures on one child. Y is total family expenditures. Expenditures on two adults and two children in this hypothetical family is then represented by the following equation:

$2*A + 2*(.4*A) = Y$

$A = .36Y$, and the amount spent per child is .4*A or 14.5%.

[99] *See* EXPENDITURES, *supra* note 61, at 2-29 to 2-30.

[100] *See* EXPENDITURES ON A CHILD BY FAMILIES, *supra* note 78.

[101] The budgetary components include expenditures for the following: housing, food, transportation, children's clothing, health care, childcare and education, and other miscellaneous goods and services. Multivariate analysis was used to estimate expenditures for each category (which were the dependent variables) and the explanatory or independent

households had spent on each item and allocated the item among members of the family either according to ratios from other studies or per capita.[102]

This study's main weakness is that it allocates major categories of expenditures per capita among all family members.[103] It makes no attempt to determine what the extra cost of a child really is. The cost of a child is probably overestimated because the extra cost is likely to be less than the average expended on each household member.[104] Nevertheless, the order of magnitude of its conclusions is interesting. For husband-wife, middle-income families (i.e., before-tax income between $32,000 and $54,100 in 1993 dollars), a two-child household spends an average of $7370 per child or $14,740 for both children. The amount spent on both children is 34% of the average before-tax income of $42,600.[105] For the middle-income family with two adults and only one child it is estimated that $9286 is spent on the child, or 22% of the average before-tax income of $42,600.[106]

The three studies discussed above all yield estimates of how much a hypothetical household might spend on the children. They cannot be directly compared since two of the studies use total household expenditures as a base, while the one from the Department of Agriculture uses before-tax income. However, if used to attribute the appropriate amount of income to children, they all indicate that substantial amounts of family income would be taxed to the children. There is probably little public support for the significant reduction in tax liabilities of affluent families that would result from such attribution.

D. *Tax Credit*

The fourth method that has been suggested for taking account of the effect of children on tax liability is a per-child credit. If refundable, it would be equivalent to the government paying the parents a fixed sum annually for each child. If nonrefundable, it would be equivalent to the government paying the fixed sum but only to the extent that the parents would otherwise have owed taxes. The usual distinguishing characteristic of a credit is that it does not

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variables were dummy variables representing family income, size of household, and age of children. *Id.* at 3–4.

102 Food and health care were divided according to ratios from other studies. Housing, transportation that is not work related, and other miscellaneous goods and services were allocated per capita among household members. Children's clothing and childcare and education were assumed to be spent equally on each child. *Id.* at 6.

103 *Id.*

104 *See supra* note 81 and accompanying text.

105 *Id.* at 16, Table A.

106 *Id.*, Table A, n.1.

depend on the income or tax bracket of the taxpayers.[107]

As is usually recognized, a per-child credit is better justified as a way of subsidizing the rearing of children than of refining ability to pay.[108] A simple example illustrates the reason. If a parent with one child is in the 10% bracket, a $500 per-child credit results in her paying the same tax as another person without children who has $5000 less income. Consequently, a person with one child and income of $20,000 would be paying the same tax as another person with no children and $15,000 income. On the other hand, if another (more affluent) parent with one child is in the 20% bracket, the same $500 credit results in this parent paying the same tax as another person without children who has $2500 less income. Consequently, a person with one child and income of $50,000 would be paying the same tax as another person with no children and $47,500 income. Traditional notions of ability to pay cannot explain why a person with one child and $20,000 income should have the same ability to pay as a person with no children and $5000 less income, while another person with one child and income of $50,000 should have the same ability to pay as a person with no children and only $2500 less income. The income differential between two families with the same economic well-being, one with a child and one without, should not decrease as income increases.[109] We expect a family to spend more on a child as its income increases.

Theoretically, a per-child tax credit could be the cost of supporting a child at subsistence.[110] With a credit of this size the cost of raising a child would to a large extent become a governmental, rather than a private, responsibility. The overwhelming political consensus seems to be against such a radical restructuring of the financial burden of supporting a child.

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[107] A fixed credit is being assumed. It is possible to structure a credit that varies as income increases. For example, a credit that increases as income increases could have the same effect as a deduction.

[108] *See* Brannon & Morss, *supra* note 47, at 604–06; Pogue, *supra* note 47 (viewing credit as appropriate way for government to subsidize expenditures on children).

[109] In Part III, I argue for tax allowances for children for low and middle income families and no tax allowances for affluent families. This position, however, does not reflect application of a single approach to ability to pay, but rather a change in approaches.

[110] George McGovern's initial tax proposal in the 1972 presidential campaign included a $1000 per-child credit, equivalent to $3547 in 1994. George McGovern, *On Taxing & Redistributing Income*, N.Y. REV. BOOKS, May 4, 1972 at 7. *See also* COUNCIL OF ECONOMIC ADVISERS, ECONOMIC INDICATORS JANUARY 1979; COUNCIL OF ECONOMIC ADVISERS, ECONOMIC INDICATORS FEBRUARY 1986; COUNCIL OF ECONOMIC ADVISERS, ECONOMIC INDICATORS JANUARY 1988; COUNCIL OF ECONOMIC ADVISERS, ECONOMIC INDICATORS JANUARY 1995 (prepared for the Joint Economic Committee).

III. CHILDREN AND ABILITY TO PAY—GENERAL CONSIDERATIONS

A. *Horizontal and Vertical Equity*

As is usually recognized, appropriate tax allowances for children involve horizontal equity, which is the principle that taxpayers with equal ability to pay tax should be making equal sacrifices. A comparison of two unmarried adults (A and B) illustrates this principle. Each has income of $75,000, but A is childless and B is the parent of two young children. The first issue is whether there should be any tax allowances for children at all in this situation. If A and B have equal ability to pay, they should have equal tax liability. If, on the other hand, we conclude that B's ability to pay is lower than A's, we need to determine what income a childless person should have for her tax capacity to be the same as B's. If that income is $65,000, then an equal sacrifice should be required of B and a childless person with income of $65,000 in determining their respective tax liabilities.[111]

It may appear that the appropriate tax allowances for children can be determined without concern for vertical equity, which is the principle that a person with greater ability to pay than another should be bearing an appropriately higher tax burden. The issue of how much more tax a person with $60,000 income should pay than a similarly situated person with $20,000 income is conceptually separate from whether a tax allowance for children is appropriate and what amount it should be. After any tax allowances for children have been established, tax rates and other aspects of the tax structure can, at least theoretically, be set to produce desired tax revenues and the appropriate degree of vertical equity. This reasoning, however, ignores a basic problem—the effect of generous exemptions on tax rates.

Generous exemptions result in a smaller tax base; consequently, marginal and average rates[112] must then be higher to produce a given amount of revenue.[113] There is, however, a benefit to keeping tax rates as low as

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[111] B and the single person making $65,000 (whom we can call "C") should probably not pay equal amounts of tax. An equal sacrifice, which is appropriate, would mean that B and C would have the same economic well-being after-tax since they had equal capacity before tax. This would probably require a greater tax payment by B. For example, B and C might be equally well off after-tax if B has after-tax income of $52,000, and C has after-tax income of $45,000. B should then have tax liability of $23,000, and C should have tax liability of $20,000. *See* Eugene Steuerle, *The Tax Treatment of Households of Different Sizes*, *in* TAXING THE FAMILY 73, 81 (Rudolph Penner, ed. 1983).

[112] The marginal rate is the amount by which tax liability increases when income increases. With a marginal rate of 40%, $100 additional income results in $40 additional tax liability.

[113] For example, a fixed rate of 20% and income of $100,000 will yield tax revenues

possible. High rates, particularly high marginal rates, make the tax system more intrusive and encourage persons to change their behavior. For example, a person subject to a 50% marginal rate may choose not to work overtime since the government will claim 50% of her additional earnings; a 20% marginal rate would be less likely to have this effect. High marginal rates also increase the value and importance of tax planning by increasing the value of tax losses.[114] Therefore, high marginal rates encourage taxpayers to invest in tax shelters, which usually produce (at least in early years) tax losses that exceed economic losses. It is widely acknowledged that one of the benefits of the Tax Reform Act of 1986 was that it significantly reduced marginal tax rates.[115] Of course, one may still favor generous allowances for children if it is concluded that they are necessary to distinguish among households of different sizes. Nevertheless, the effect of child allowances on tax rates and other attributes of the tax system should be considered.[116]

Most would agree that the tax liability of nonaffluent persons needs to be adjusted for any children who are members of the household. The children consume resources that otherwise would be available to the adults, and society has an interest in assuring that the parents have sufficient resources to support the children. This consideration should outweigh any effect that the allowance might have on tax rates. In addition, the marginal rates for low and middle income persons generally do not exceed 15%, and the economic effect of these

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of $20,000. With a $20,000 deduction and $80,000 taxable income, a fixed rate would have to increase to 25% to yield the same revenue. In this example, the marginal rate would equal the fixed rate at all income levels.

[114] With a 50% marginal rate, $100 of tax losses results in a saving of $50. With a 20% marginal rate, the saving would be only $20.

[115] STAFF OF JOINT COMM. ON TAXATION, GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, 100th Cong., 1st Sess. 35 (1987); ECONOMIC REPORT OF THE PRESIDENT 65 (1987); George J. Church, *The Making of a Miracle; Against All Odds; Congress Hammers Out a Radical Tax-Reform Plan*, TIME, Aug. 25, 1986, at 12; Jack Egan et al., *Changing Course*, U.S. NEWS & WORLD REP., Oct. 6, 1986, at 46; Tom Morganthau et al., *A Capitol Miracle*, NEWSWEEK, Aug. 25, 1986, at 14, 15; Jeffery L. Sheler et al., *In Prospect: Deep Cuts for Millions; Suddenly, a Chance for Tax Reform*, U.S. NEWS & WORLD REP., May 19, 1986, at 16.

[116] The interaction between allowances for children and tax rates has often been ignored. *See* Brannon & Morss, *supra* note 47, at 601; Steuerle, *supra* note 111, at 81–82; Zelenak, *supra* note 1, at 364. *But see* Seneca & Taussig, *supra*, note 86, at 253 (stating that "further erosion of personal income base" because of deductions for children should be weighed against horizontal equity); GROVES, *supra*, note 47, at 35–36; SELTZER, *supra* note 9, at 31–33; Peter Gottschalk, *Deductions Versus Credits Revisited*, 29 NAT'L TAX J. 221, 225 (1976).

tax rates is probably modest.[117]

In my opinion, the argument for tax allowances for children of affluent parents is much less compelling.[118] In addition, marginal rates for affluent persons are fairly high, reaching a maximum of 39.6% merely for federal taxes,[119] with state and local income taxes often pushing the combined marginal rate much higher. It is important that marginal rates for the affluent be as low as possible while obtaining the desired revenues from them.

It appears that changes in the personal exemption for affluent persons can offset small, but noticeable, changes in rates, if revenues from this group are held constant. Calculations using data from 1992 returns for taxpayers with adjusted gross incomes between $100,000 and $200,000 are illustrative. A $2300 personal exemption (the amount of the deduction in 1992) for dependents only (not including the exemptions for the taxpayers themselves) would generate deductions that are about 2.5% of taxable income.[120] The revenue loss from allowing the full personal exemptions for dependents to these taxpayers would slightly exceed 3% of their tax liability and .7% of their taxable income.[121] A $4000 personal exemption, which conforms with recent proposals,[122] would result in a revenue loss that is 5.4% of tax revenues and 1.3% of taxable income. A revenue loss of 1.3% of taxable income clearly will have a noticeable effect on statutory rates if revenues are to be kept constant.[123]

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[117] This conclusion is not valid if a taxpayer is in the phaseout range of the earned income tax credit. Marginal rates then would be quite high. Alstott, *supra* note 36, at 549–52.

[118] *See infra* notes 149–154 and accompanying text.

[119] In addition, the phaseout of itemized deductions and personal exemptions can further increase the marginal rate. *See* I.R.C. §§ 68, 151(d)(3) (1994).

[120] For persons with adjusted gross incomes between $100,000 and $200,000, there was an average of 1.08 exemptions for dependents per return. INDIVIDUAL INCOME TAX RETURNS, *supra* note 72, at 80 (Table 2.3). Average taxable income for these returns was at $99,838. *See id.* at 26 (Table 1.1). Reported taxable income reflects deductions for personal exemptions (although the exemptions would be partially subject to the phaseout). The relatively small changes in taxable income that would result from changes in personal exemptions are being ignored.

[121] A marginal rate of 30% was used for determining revenue loss because about 62% of these returns were subject to a 31% marginal rate and virtually all the remaining returns were subject to a 28% marginal rate. *Id.* at 96 (Table 3.5). Average tax per return for this income group was $24,022. *Id.* at 26 (Table 1.1).

[122] *See* Zelenak, *supra* note 1, at 382.

[123] As an example of the effect of the personal exemption on marginal rates with these parameters, consider an economy with only one affluent person ("A") with taxable income of $100,000. The first $50,000 is taxed at 10%, and the next $50,000 is taxed at 30%, the top marginal rate. A pays $20,000 in taxes.

B. *Low and Moderate Income Families*

Few will disagree with the conclusion that there needs to be some type of tax allowance for children in low income families. For these families children unambiguously reduce the ability to pay. When most or all resources are being used for subsistence, each member of the family is making an economic sacrifice if there is an additional person to support and no additional income. Furthermore, we may feel fairly confident of our ability to compare the economic well-being of families of different sizes when their income levels hover around subsistence. The family that can barely afford necessities is not as well off as the family that can afford to eat meat or fish several times a week. By this criterion children clearly reduce the economic well-being of low income families.

The issue then becomes how much of a deduction to allow a low income family for each child. A sensible starting point is that families at or below the poverty threshold should not have to pay any income taxes. Although the poverty threshold is inherently subjective, it represents a societal judgment that persons below it do not have an acceptable standard of living and thus represents a reasonable level of income at which tax liability should begin. Congress has apparently accepted this reasoning.[124] Consequently, a deduction for the subsistence cost of raising a child, which is the increase in the poverty threshold on account of the child, should be allowed low income families. This deduction will keep those below the poverty threshold off the tax rolls.

A deduction for the subsistence cost of a child should also be available for middle income families. If the effect of children on ability to pay is recognized for parents who are at or close to subsistence, then the tax allowance should not be suddenly revoked when the parents' income is modestly above subsistence. For such families as well, paying for necessities consumes a major portion of available resources and supporting a child reduces what is available for others.

Assume that A deducts $5000 in personal exemptions for dependents; the deductions save her $1500 in taxes, or 1.5% of taxable income. If A loses the $5000 in personal exemptions, her taxable income becomes $105,000. The top marginal rate can be reduced from 30% to slightly more than 27%, with tax revenues paid by A remaining at $20,000.

[124] In the Tax Reform Act of 1986 Congress established the amounts of the standard deduction and the personal exemption so that, except for single persons, all those with incomes below the poverty threshold would not have to pay federal income taxes. The Committee Reports provide reasons for concluding that the income of single persons is probably not a good indicator of whether the individual is impoverished. S. REP. No. 313, 99th Cong., 2d Sess. 32–33 (1986), *reprinted in* 1986-3 (Vol. 3) C.B. 1, 32–33; H.R. REP. No. 426, 99th Cong., 1st Sess. 83 (1985), *reprinted in* 1986-3 (Vol. 2) C.B. 1, 83. *See also Dependency Exemptions*, *supra* note 1, at 866–68.

Since persons with incomes above the poverty thresholds are expected to pay income taxes, any amount above subsistence expended on the children should presumably be attributed to the children and should be subject to tax.[125] However, if we assume that the middle income families with whom we are dealing are subject only to the 15% tax rate, attributing income to the children would have no effect on tax liability.[126] The income would still be subject to a 15% tax rate. On the other hand, if we include as middle income families those where the parents are subject to a 28% or even greater marginal rate, they should be allowed a greater tax benefit. In addition to the deduction for a child, some of the income that is taxed at a 28% or greater rate should be attributed to the children and taxed at the 15% rate. How much income should be taxed at the lower rate depends on judgments about several factors, including which families should be characterized as "middle income." These issues are inherently subjective, and it is unnecessary to resolve them in this Article.

Current law allows a deduction for each child that approximates the amount needed to support that child at subsistence according to official definitions of poverty.[127] The 1995 Poverty Guidelines published by the Department of Health and Human Services provide that each additional child in a household adds an additional $2560 to the poverty threshold,[128] and the 1995 personal exemption for a child is $2500.[129] Each amount is indexed to the Consumer Price Index and increases annually.[130] Therefore, it is important to evaluate the sufficiency of the poverty guidelines.

The official poverty guidelines used in the United States are based on a series of studies undertaken in the 1960s for the Social Security Administration by Millie Orshansky.[131] The poverty threshold was determined by first

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[125] It is being assumed that income should be attributed to the person who benefits from it. For discussion of this assumption, see *supra* note 68.

[126] *See supra* notes 69–71 and accompanying text.

[127] *See supra* note 124.

[128] Poverty Guidelines, *supra* note 48, at 7772. These guidelines are primarily used to determine eligibility for various government programs. There is another set of poverty guidelines that is published annually by the Census Bureau and used primarily for statistical purposes. The HHS guidelines issued in a particular year and used for eligibility in that year will be comparable roughly to the Census Bureau poverty thresholds for the previous year. There are also minor differences between the two methods in adjustment for family size. RUGGLES, *supra* note 53, at 10 n.1.

[129] Rev. Proc. 94-72, 1994-2 C.B. 811.

[130] I.R.C. § 151(d)(4)(A) (1994); Poverty Guidelines, *supra* note 48, at 7773.

[131] *See* Millie Orshansky, *Counting the Poor: Another Look at the Poverty Profile*, 28 SOCIAL SECURITY BULL. 3 (January 1965); Millie Orshansky, *Children of the Poor*, 26 SOCIAL SECURITY BULL. 3 (July 1963), cited in RUGGLES, *supra* note 53, at 3-5, 33-35. *See also* Trudi J. Renwick & Barbara R. Bergmann, *A Budget-Based Definition of Poverty, With*

estimating the cost of a nutritionally adequate diet for various types of families. This amount was then multiplied by three on the assumption (supported by some evidence from surveys) that low income families spent approximately one third of their income for food. The original design of the poverty index could, of course, be criticized. However, the index was widely accepted, and its widespread use was an indication that it conformed with public opinion on the determination of what constitutes poverty.[132]

Possibly the most serious shortcoming in the current poverty guidelines is the lack of any adjustment since 1969 except for general indexing by the Consumer Price Index. Three types of problems can be identified.[133] First, society may revise its standards for what is a minimally necessary standard of living. For example, prices tend to rise more slowly than incomes, and thus the gap widens between what is needed to emerge from poverty and what the average person is consuming.[134] We should expect that, as our general standard of living increases, our determination of what is needed for a minimally adequate lifestyle should also increase. Second, there has been a change in consumption patterns over the last twenty-five years. For example, the increased prevalence of women working and two wage earners per household has changed the importance of expenses like commuting costs and taxes. Also, new products have appeared that were not available in earlier years. At one time telephones and televisions were not considered "necessities"; now they probably should be. Videocassette recorders, microwaves, and even computers may be considered necessities in the near future. Third, to the extent that low income persons have different consumption patterns than middle and high income persons, changes in the overall consumer price index will not reflect changes in the cost of living of low income persons. For example, if low income persons spend a disproportionate amount on shelter compared to the population at large, they will be more severely impacted by an increase in the cost of housing.

Many different methods have been used to estimate poverty thresholds, and the results, not surprisingly, differ significantly. In a study authorized by the Joint Economic Committee of Congress, a panel for the National Research Council listed eleven published estimates for two-adult, two-children

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an Application to Single-Parent Families, 28 J. HUM. RESOURCES 1-5 (Winter 1993).

132 *See* RUGGLES, *supra* note 53, at 38.

133 This discussion is based on the analysis in RUGGLES, *supra* note 53, at 39-51.

134 The official poverty guideline was first developed for use in 1963. Between 1963 and 1992 median after-tax income for a four-person family increased by 28% in real terms. However, the poverty thresholds were increased only by the cost of living and thus did not increase at all in real terms. NATIONAL RESEARCH COUNCIL, MEASURING POVERTY: A NEW APPROACH 30 (1995).

families.[135] The official poverty guideline was the lowest, with the highest estimate being 50% larger than the official guideline. Currently, the official poverty guidelines calculate that the subsistence cost of an additional child is $2560. A 50% increase would result in a subsistence cost of $3840.[136]

To the extent there is any uncertainty about the appropriate size of a deduction for a child, it should be resolved in favor of a larger deduction. Certainly, it is better to undertax, rather than overtax, low and moderate income families with children. Any lost revenue should be relatively small, especially if the benefit is not fully extended to affluent families. Consequently, a deduction of at least $4000 per child for low and middle income families seems appropriate.

There are three additional issues concerning tax allowances for low and moderate income families. The first is whether the deduction allowed for each child should vary according to the number of children. It should not cost a family with two children twice as much to support the children and remain at the same level of economic well-being as it costs a family to support one child. Similarly, it should not cost a family with three children 50% more to support the children than it costs a family with two children. Studies confirm that, although total expenditures on children generally increase when the number of children increases, the amount spent per child decreases.[137] One reason for this is economies of scale. For example, children can share a room and hand-me-down clothes, and food can be purchased more economically in larger quantities.[138] Although estimates vary, there is some indication that the difference in costs can be substantial. One estimate shows the cost per child going down by 25% when a second child is added to a family and going down by another 20% when a third child is added.[139] The primary purpose of personal exemptions should be to remove families with income at or below subsistence from the tax rolls. If it is confirmed that there is a substantial reduction in subsistence costs for additional children, the personal exemptions should be adjusted accordingly. As the number of children in a family increases, the deduction for each child would decrease (although the aggregate deductions for all children in the family would continue to increase). Making these distinctions would add some complexity to the tax laws, but tables listing the total exemptions based on number of children per family should make the

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[135] *Id.* at 47 (Table 1-3).

[136] The 50% increase in the subsistence cost of a child is only illustrative since the studies may calculate the subsistence cost of a child in a different manner than the official guidelines.

[137] EXPENDITURES, *supra* note 61, at 4-18 to 4-20 (discussing several studies).

[138] *Id.* at 2-11.

[139] *See id.* at 4-19 (Table 4.5) (Betson's Engel estimates).

task manageable.

A second and similar issue is whether the deductions should vary according to the age of the children. Amounts spent on children increase significantly as they become older.[140] The study by the Department of Agriculture shows that, for low income families with two adults and two children, the annual amount spent on a child is estimated to be $4960 for a child less than two years old and $6260 for a child between fifteen and seventeen years old, a 26% increase.[141] As with the number of children, there is a strong theoretical argument for taking account of the effect of age on subsistence cost in determining the personal exemptions. The problem is that exemption amounts depending on ages of children may increase complexity of the tax forms substantially. An additional reason for not taking account of age is that the deductions will balance out over the childhood years. The issue is "only" one of timing.

The third issue is the most complex: whether there should be a greater deduction for children of single-parent families than two-parent families. A larger deduction might be appropriate because, with only a single parent, there is less adult time to be devoted to the children and correspondingly cash expenditures may have to be increased to compensate for the lack of time. For example, convenience foods and frozen dinners, which are more expensive than basic food products, might have to be purchased more often by single parents because they have less time to prepare meals.

Single parents spend a greater proportion of their income on children than two-parent families with the same total number of children, but this result is not surprising.[142] With less people to share the income, one would expect each person in a family to receive a greater share.[143] A comprehensive study completed by Professor David Betson of Notre Dame and reported by the Department of Health and Human Services, using several different methods for estimating expenditures on children, allows us to compare expenditures by one

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140 *Id.* at 4-19 (Table 4.5), 4-21.

141 EXPENDITURES ON A CHILD BY FAMILIES, *supra* note 78, at 16 (Table A). There is not, however, a steady increase.

142 *See* EXPENDITURES, *supra* note 61, at 4-10. In the Department of Agriculture study, expenditures on children by families with income less than $32,000 was quite similar for both two-parent and one-parent families. However, the average income of the two-parent families was $20,000, and the average income of the one-parent families was only $13,700. EXPENDITURES ON A CHILD BY FAMILIES, *supra* note 78, at 16 (Table A), 22 (Table G). Therefore, the single parents were clearly devoting a greater proportion of their income to their children than the two-parent families.

143 For example, compare a single-parent family and a two-parent family, each with total expenditures of $20,000 and two children. If all goods were shared per capita, then expenditures on the two children in the one-parent family would be $13,333 and expenditures on the two children in the two-parent family would be $10,000.

and two-parent families. Table VI is adapted from this study and shows, for "low-expenditure" families with two children, the percentage of expenditures made on *each* adult, assuming expenditures are divided equally between the two parents in a two-parent family.[144] Four different methods of estimating expenditures on children (using different criteria of economic well-being) are reported in Table VI.[145]

Table VI

AVERAGE PERCENT OF EXPENDITURES ON EACH ADULT IN LOW-EXPENDITURE TWO-CHILD FAMILIES[146]

	Number of Adults	
	1	2
Method of Estimation		
Engle 1	19%	26%
Engel 2	34%	27%
Rothbarth 1	45%	32%
Rothbarth 1	46%	33%

The results from the Engel 1 method are particularly dramatic. A smaller percentage of family expenditures is spent on the single parent in a two-child family than the average spent on either parent in a comparable two-parent family. If this result is valid, then clearly the cost of children to a single parent

[144] Table VI was adapted from EXPENDITURES, *supra* note 61, at 4-9 (Table 4.2), 4-11 (Table 4.3). Tables 4.2 and 4.3 reported results for low, medium, and high expenditure families. Table VI only provides results for low expenditure families, which are families with annual expenditures between $5000 and $15,000. The results for medium and high expenditure families would, for each method of estimation, be very close to the results reported in Table VI.

Tables 4.2 and 4.3 report the amounts spent on children; the amount spent on adults was then easily determined. In a two-adult household the amount spent on adults was divided by two.

[145] Additional methods were also used, but were rejected by Betson for reasons unrelated to the comparison of one and two-parent families. *See* EXPENDITURES, *supra* note 61, at 4-9 (Table 4.2, note "e").

[146] The estimators use different measures of economic well-being for determining how family expenditures are divided between adults and children. *See supra* notes 85–99 and accompanying text. Engel 1 uses percentage of total exependitures for food consumed at home; Engel 2 uses percentage of total exependitures for food consumed both at and away from home; Rothbarth 1 uses total expenditures on adult clothing, alcohol, and tobacco; Rothbarth 2 uses expenditures on adult clothing. For a general discussion of the Engel and Rothbarth methods for estimating expenditures on children and adults, *see supra* notes 85–99 and accompanying text.

is greater than for two-parent families. The other methods show the single parent receiving a greater percentage of family income than the average going to either parent in a two-parent family, but it is not clear whether, without the economies of scale and increased availability of time when two adults are present, the single parent is as well off economically as those in the two-parent family.[147]

Therefore, there are two related issues when comparing one- and two-parent families with the same income: whether the increased expenditures on children by the one-parent families represent in part a greater burden and whether tax allowances for children should reflect any portion of the extra costs. I would support larger tax allowances for children in households with single parents, if more detailed data confirm that the economic burden is greater for low income single parents and provide some basis for estimating the magnitude of the difference.[148]

C. *Affluent Parents*

Although the income level where middle income status ends and affluence begins is inherently arbitrary, the fact that there are both middle income and affluent persons should be noncontroversial. Consequently, it is meaningful to discuss the appropriate tax benefits for the costs of raising children in affluent families separately from middle and low income families. In my opinion, determining the appropriate tax benefits for affluent parents is a much more complex undertaking than for low and middle income parents. I believe that the merits of any proposal with respect to affluent parents will not be based on immutable principles, but rather on the weighing of alternatives and possibly the acceptability of simplifying assumptions.

Certainly, a cogent argument can be made that children should reduce the tax liability of affluent parents. Children have economic needs that must be met, and the parents (no matter how affluent) must redirect some of their resources to meet those needs. An affluent family with a new baby must purchase items such as baby formula and diapers, while an otherwise identical

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147 The study by Lazear and Michael allows a similar comparison, although not limited to low income families. In a household with two children and one adult, 48% of income would be spent on the one adult; in a household with two adults and two children an average of 36% of income would be spent on each adult. *See* EXPENDITURES, *supra* note 61, at 4-19 (Table 4.5), 4-21; LAZEAR & MICHAEL, *supra* note 64, at 86.

148 Some might argue that a greater tax allowance with respect to a child of an unmarried parent than a child of married parents would penalize married parents, and thus encourage divorce and discourage marriage. For discussion of these issues, see *infra* notes 167–68 and accompanying text.

family with no children can spend that money on a luxury car. It does seem appropriate that the expenditure on formula and diapers be treated differently for tax purposes than the purchase of a compact-disc player for one's automobile. The implication is that an appropriate amount of the first family's income is benefiting the child and should be taxed to the child. Because diapers and baby formula are satisfying more basic needs than the disc player, the income being used for the former should be taxed at a lower rate than the income being used for the latter. The first family should have more of their income be tax-free or be taxed at a lower rate than the second family.[149]

Members of the second family may disagree with this reasoning, however. Presumably the first family chose to have the child and decided that the benefits outweighed any lost consumption. The second family may have made the opposite choice; its members would argue that those in the first family, with a well-fed child and a tape deck in their car, have just as high a standard of living as they do with their compact disc player. The spending on the child may be more socially important than the luxury car, but social importance is usually not a determinative factor for tax liability: a gambling loss is treated the same for tax purposes as the purchase of tickets for serious drama.

This analysis could, of course, be made for low and middle income families as well as for affluent families. We can *choose* to treat consumption by the child as adding to the parents' economic well-being in either case. Nevertheless, it seems reasonable to conclude that a person who spends money on her child rather than purchasing a custom-made suit or a piece of jewelry has not diminished her economic well-being. The consumption by the child can be considered a substitute for the suit or jewelry. It seems less reasonable to conclude that consumption by a child is a substitute for a needed car repair.

The contention that the ability to pay of affluent parents is not reduced by children can be based on three propositions. Although all three might not be logically necessary, realistically the reader probably must accept all three to accept the conclusion. They are as follows: (1) most persons plan the number of children that they have and are generally successful in this planning; (2) those who have children do not regret their choice, especially when the children are still young (and thus qualify for a tax allowance); and (3) parents obtain happiness and fulfillment from their children. The first and second propositions are quite straightforward, and require relatively little discussion.

In most cases having a child is the result of a conscious decision to become a parent. Of course, planning is not perfect. Some couples have a child earlier than they had planned or end up with four children when they had intended to

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[149] It may be decided that some of the income used for the child's benefit should be taxed at a zero rate, which would be equivalent to a deduction to the parents. *See supra* note 73.

have only three. Few, however, plan to have only one or two children and through "accidents" have five or six. It should only be necessary that people have a large degree of control over the number of their children, not perfect control. The rules of taxation cannot be adjusted to the particularities of each person; it is sufficient that they seem reasonable and are appropriate for most people.

Second, the decision to have a child is made with imperfect knowledge and has an impact for many years beyond the time of conception or birth. Nevertheless, the decision is typically made with some awareness of the future, and few parents would say that economic or other conditions have changed so much that they regret having one or more children. Once again, this proposition need not be true for everyone, only for most of us.

The third proposition is more complex. It is not merely that there should be no tax allowance for children since parents have made a voluntary decision and are happier as a result. The argument is also that much, if not all, that is spent on a child also benefits the parent directly or indirectly. Distinguishing between amounts spent for the benefit of the child and those spent for the benefit of the parents is inherently arbitrary.[150]

Parents obtain satisfaction from consumption by their children in two ways.[151] The first is simply altruism; parents are happy when their children are happy. Spending money on a child may make the child happy, but the parent also obtains a benefit from the child's happiness. A parent who takes a child on a vacation that the child likes will be delighted to see the child having a good time, and consequently the parent will enjoy the vacation more himself. In addition, the parent might obtain pleasure directly from a child's use of resources regardless of any pleasure obtained by the child. One example might be a cute outfit purchased for a little child. Another might be piano lessons that the child dislikes, but the parent gains satisfaction from having a child trained in music. In both cases, the parent's pleasure is independent of the child's feelings. Finally, some events, such as a family dinner, may contribute to a parent's satisfaction in both ways. The parent not only enjoys seeing the child

[150] One major category of expenses to which this argument might not apply is payment of college tuition and related expenses by the parents. In my opinion, there is typically less of a direct benefit to the parents from paying for college than for other expenses incurred in raising a child. One reason, of course, is that the benefits of college will generally be realized only after the child has become independent of her parents. A possible implication is that the expenditures for tuition should be deductible by the parent and taxed to the child, but this would differ from the normal tax treatment of gifts. Whether there should be special treatment of payment of college expenses by parents is beyond the scope of this paper.

[151] For a discussion of the interrelationship between utility of parents and children, see LAZEAR & MICHAEL, *supra* note 64, at 54–65.

eating and having a good time, but also places independent value on eating together as a family.

Of course, this reasoning could be extended to all amounts spent on a child. A parent obtains pleasure not only when the child does something special, but also when the child does ordinary things. Since a parent obtains satisfaction from consumption by his child, it is appropriate that he not receive any special tax benefits for the costs of raising the child.

One objection to this analysis might be that it considers only the well-being of the parents and ignores that of the children.[152] It is true that the well-being of the child is not being considered in the determination of tax liability,[153] but it is appropriate to use the well-being of the parent as a proxy for that of the entire family.[154] In addition, the economic well-being of a child loses much of its meaning once basic economic needs have been met. Is an infant or young child better off in a big room than in a small one? Probably the child is supremely indifferent. On the other hand, any contention that a lack of tax allowances for children of affluent parents shows that society does not value children is unwarranted. One could argue that the government's role is to build and support excellent schools and playgrounds and (perhaps) provide health care, not to subsidize private costs of feeding and clothing children in affluent families.

Finally, to recapitulate one point, I am not contending that there is only one correct method of taxing affluent families with children. Rather, the claim is only that not providing tax allowances to affluent families is a reasonable approach. Whether or not deductions, credits, or other tax benefits for a child should be allowed depends on practical decisions and the weighing of alternatives.

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[152] *See* JANE G. GRAVELLE, CONGRESSIONAL RES. SERV., FEDERAL INCOME TAX TREATMENT OF THE FAMILY 12 (1991), cited in Zelenak, *supra* note 1, at 360.

[153] To see this, consider two similar families, each with income of $150,000, except that one family has one child and the other family has two. Presumably greater expenditures are made on the child in the first family than on either child in the second family (although the sum of expenditures on both children in the second family should exceed the expenditures on the child in the first family). If there are no tax allowances for children, the total tax liability of the two families would be the same. Therefore, the greater economic well-being of the child in the first family, relative to either child in the second, is not relevant in determining tax liability.

[154] The parents' decisions about a good lifestyle should be applicable to their children. In the prior footnote the parents in the second family made the choice that they would be better off with two children than with one. We might then conclude that the well-being of each of their two children is also enhanced by the presence of a sibling. Each child may have a smaller room than he or she would have in a one-child family, but this child also has a brother or sister, with a separate room, with whom to play and fight.

IV. Evaluation of Current Law and Some Tentative Proposals

A. *Replacement of Personal Exemption by Credit*

In the previous section I have contended that low and moderate income parents should be allowed a tax benefit that is substantially greater than the current $2500 deduction for each child. There is no conceptually correct number, but a $4000 deduction (or equivalent benefit) can be easily justified. I have also suggested that the benefit should probably vary according to the number of children although I did not provide a specific schedule or formula.[155] Although the latter proposal would increase complexity to a small degree, I think the tax forms could easily accommodate this change by listing the total amount of personal exemptions for various family sizes.

I have also contended that there is not a compelling need to provide any tax benefits to affluent parents. The phaseout of the personal exemption, which starts at $172,050 for married persons filing jointly and $143,350 for those filing as heads of households,[156] is consistent with this position, although it might be argued that it should begin at lower income levels. Congress did not explain any rationale for the phaseout, but it might be noted that it was enacted at the same time that the personal exemption was almost doubled.[157] When Congress enacted the Tax Reform Act of 1986,[158] it was willing to increase the personal exemption substantially, but unwilling to extend the benefits to high income taxpayers. This intent to deny tax allowances to affluent parents for their children is also illustrated by the disallowance of personal exemptions in the computation of the alternative minimum tax, which affects only high income taxpayers.[159]

The problem with deductions (or credits) that are phased out at higher incomes is that they are equivalent to increases in the marginal rate for affected taxpayers.[160] The existing phaseout of personal exemptions is equivalent to an

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155 If this proposal were accepted, the recommended $4000 deduction (or equivalent benefit) would be the average amount allowed for children. The deduction for the first child might be larger than $4000, and the deduction for the second child might be smaller than $4000.

156 Rev. Proc. 94-72, 1994-2 C.B. 811.

157 *See supra* notes 12–14 and accompanying text.

158 Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085.

159 I.R.C. § 56(b)(1)(E) (1994). For discussion of the alternative minimum tax, see *supra* notes 15–19 and accompanying text.

160 An increase in income would cause a decline in deductions, and the decline in deductions would cause an additional increase in taxable income. Consequently, tax liability would increase by a greater amount than would be indicated by the statutory rates. For an

increase in the marginal rate of almost three-quarters of a percentage point for each exemption for a married couple who is in the 36% nominal bracket and has adjusted gross income between $172,500 and $294,550.[161] Consequently, with four personal exemptions, there is an increase in the marginal rate of almost three percentage points. One result is that the marginal rate goes down as soon as adjusted gross income exceeds $294,500. A decline in the marginal rate when income increases does seem perverse.

A fixed tax credit for each child may be an appropriate compromise. Affluent parents would obtain some tax benefit, but a limited benefit can be justified since they too must support their children. Unlike a deduction, however, a credit is not worth more to high income taxpayers than to those with low incomes; it provides a fixed benefit varying only according to number of children. A credit also avoids the need for drawing a line between moderate income and affluent taxpayers. The credit would be fully available to the affluent, but obviously a fixed benefit becomes relatively less important as one's income and tax liability increases. For a moderate income family the proposed credit should provide a tax benefit that is equivalent to the deduction that was recommended above. The recommended deduction was $4000, and the equivalent credit would be $600 since moderate income persons are in the 15% tax bracket. It might be noted that a $600 credit, although much more valuable to moderate income persons than the current $2500 deduction (which for them is equivalent to a $375 credit), is less valuable to those high income taxpayers who are still obtaining the full benefit of the deduction; a taxpayer in the 36% bracket saves $900 from the $2500 deduction.[162]

One objection to the proposed $600 credit is that it is less valuable than a deduction to those who are, at least arguably, not affluent, but in the 28% marginal bracket. For example, the current $2500 deduction is equivalent to a

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illustration, see *infra* note 161.

[161] The $2500 personal exemption for 1995 is phased out when adjusted gross income of a married couple filing jointly increases from $172,050 to $294,550. Rev. Proc. 94-72, 1994-2 C.B. 811. The loss of a $2500 deduction results in $900 additional tax liability for a person in the nominal 36% bracket. An increase in tax of $900 when income increases by $122,500 is equivalent to an increase in the tax rate of .73 of a percentage point. These computations are only approximations because the personal exemption is not uniformly phased out as adjusted gross income increases; it is reduced by two percentage points for each $2500 increase (or fraction thereof) in adjusted gross income. I.R.C. § 151(d)(3) (1994).

[162] Taxpayers can be subject to a 36% marginal rate and still be able to deduct the full amount of personal exemptions. For example, the 36% marginal rate starts at taxable income of $143,600 for married persons filing jointly in 1995, while the phaseout of personal exemptions does not begin until adjusted gross income is $172,050. Rev. Proc. 94-72, 1994-2 C.B. 811.

$700 credit to these persons. For a person filing as head of household, the 28% bracket starts at taxable income of $31,250 in 1995, and for a married couple filing jointly, it starts at $39,000.[163] On the other hand, these persons all have adjusted gross incomes that exceed $40,000 and are able to afford what many would consider comfortable, although not lavish, lifestyles. Therefore, the arguments in the previous section that the ability to pay of the affluent need not reflect the cost of children may have some relevance even if not fully applicable. The proposed credit could be defended as reflecting the economic strains of raising children for persons with incomes around $40,000, but also taking account of the benefits obtained from children and the fact that the economic burdens have in most cases been voluntarily assumed.

A phaseout of the recommended credit would also be a possibility. The small temporary increase in effective marginal rates as the credit is phased out may be warranted if it is accepted (as argued in this Article) that a tax benefit for children is not necessarily appropriate for affluent families. There is no scientific method to determine where the phaseout should begin; determination of who is affluent is a matter of judgment and politics.

B. *Head of Household Status*

The separate tax schedules for those filing as heads of households should be repealed because they primarily help affluent unmarried persons. There is no reason that a child should reduce the tax liability of an unmarried person with adjusted gross income over $150,000 by $2395, in addition to any saving from the personal exemption.[164]

On the other hand, the increase in the standard deduction for heads of households can be defended. As argued in the previous section, children may be more of an economic burden for unmarried persons than for those who are married, and a tax allowance might appropriately reflect this disparity.[165] Because the standard deduction primarily helps low and moderate income persons, the increased standard deduction can be justified as appropriately taking account of the reduced ability to pay of these persons. This justification may be puzzling since the standard deduction of a head of household is still

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[163] Rev. Proc. 94-72, 1994-2 C.B. 811.

[164] An argument for the special rate schedule might be that unmarried persons are overtaxed relative to married persons, and the special rate schedule just remedies this unfair treatment when unmarried persons have children. However, the solution would then be modification of the relative treatment of married and unmarried persons. Appropriate taxation of married persons relative to unmarried persons is beyond the scope of this Article.

[165] *See supra* notes 142–148 and accompanying text.

lower than that of a married couple. However, what is relevant is that the first child may result in greater tax saving to an unmarried person than to a married couple since the former (but not the latter) obtains a higher standard deduction because of the child. A separate issue, beyond the scope of this Article, is whether the standard deduction of unmarried persons, whether or not heads of households, is too low relative to that of married couples.

If further analysis confirms that children place more of an economic burden on unmarried than on married persons, my preference would be that an increased credit or deduction (whichever is the basic tax allowance for moderate income parents) be substituted for the increase in the standard deduction. Whether a person will benefit from an increase in the standard deduction depends on factors that have nothing to do with the effect of a child on ability to pay. For example, the increase in the standard deduction would be less useful to taxpayers in states with high income taxes than in states with no income taxes since the former are more likely to itemize their deductions and thus not utilize the standard deduction.[166]

A higher per child benefit for unmarried than for married persons is troubling in one respect. Some might assert that the tax laws would be "rewarding" unmarried parents more than married couples for having children.[167] This contention is not valid, however, if the unmarried parent is raising the child herself. When the extra benefit only reflects the additional cost of being an unmarried parent, the tax code is neutral with respect to married and unmarried parents. On the other hand, if the two parents were unmarried, but living together and raising the child, a higher benefit than that available to married parents would be unwarranted. This result is similar to the marriage penalty under current law.[168]

C. *Earned Income Tax Credit*

The earned income tax credit[169] is both a welfare program, with bigger families (up to two children) obtaining additional benefits, and an earned-income supplement, with benefits first increasing and then declining as earned

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166 *See generally* Samansky, *supra* note 31.

167 Current law already provides a greater tax benefit with respect to the first child of unmarried persons than to the first child of married persons in most cases. However, this result has attracted relatively little attention because unmarried persons with one child will still be paying more tax than similarly situated married persons with the same income. The child will only reduce their higher tax burden. *See supra* Tables III and IV.

168 As many have noted, current law discourages many two-earner couples from marrying since they will often pay less aggregate tax if they are single than if they are married.

169 I.R.C. § 32(b)(A) (1994).

income increases. Consequently, the credit raises issues beyond the topic of this Article, which is the effect of the obligation to support children on parents' tax liability. Nevertheless, in one important respect it is consistent with a central thesis of the Article—it provides greater tax benefits to low income parents than to affluent ones. In my opinion, favoring low income parents in this way is good public policy.

In two respects, however, variation in the credit amount according to the number of children is hard to justify. The first is that the credit increases as the number of children increases, but only until the limit of two children is reached. Any additional child does not increase the amount of credit. Clearly, the third, fourth, or fifth child increases the cost of subsistence, and the earned income credit should take account of this fact.

The second aspect of the credit that is hard to justify is the small extra benefit with respect to the second child. The problem is most dramatic for very low income persons. Consider, for example, a person with earned income and adjusted gross income of $6000. If she has no children, she is entitled to a benefit of $247. With one child the benefit increases by $1793 to $2040, and with a second child the benefit increases only by an additional $120 to $2160.[170] Although no income taxes would be due, she would owe employment taxes of $459. Therefore, the total amount available to this person would be $5788 if there are no children, $7581 if one child, and $7701 if two children. Certainly, with two children the economic deprivation would be greater than with one child; the additional child adds much more than $120 to the cost of living. Perhaps, Congress is assuming that these families actually have additional resources available. However, the more likely conclusion is that Congress has not analyzed the credit in this way.

It is true that, at higher income levels, a second child increases the amount of credit more dramatically. Consider an unmarried person with earned income and adjusted gross income of $10,000. The credit is zero if she has no children, $2094 if she has one child, and $3110 if she has two children.[171] The second child increases the credit by almost 50%.[172] The increase resulting from the second child may seem relatively high, but the correct perspective is after-tax (including "after-credit") income. In this case, the total resources available for consumption are $8695 if there are no children, $11,329 if there is one child, and $12,345 if there are two children.[173] With the second child, the amount available for living costs increases by less than 9%, which seems

[170] *Id.*

[171] *Id.*

[172] *Id.*

[173] The amount available after taxes is computed after both income and payroll taxes, as well as the earned income credit.

clearly less than the extra economic burden.

Finally, a more basic restructuring of the credit may be appropriate. Under the current earned income credit, the benefit with respect to a child initially increases as income increases. For example, the extra benefit when a person is supporting a second child is $80 when adjusted gross income and earned income are $4000, and $1016 when adjusted gross income and earned income are $9000.[174] This result seems perverse because the first family presumably needs the extra support more than the second family. One possibility is to bifurcate the credit into an earned income credit that does not depend at all on the number of children and a child credit that does not depend at all on the amount of earned income; both credits could be refundable. Although the earned income credit would increase as earned income increases up to a fixed amount, the child credit would not. The child credit could be payable to parents at all income levels or could decrease as income exceeds a set amount. Replacing the credit with these two separate credits may allow it to achieve the two goals of subsidizing work and supporting children.[175]

V. CONCLUSION

The Article has explored how the obligation to support children should affect parents' tax liability. It has attempted to establish three principles. First, there is no theoretical approach that should be systematically used for all taxpayers in determining the effect of children on appropriate tax liability. Second, low and middle income parents should be allowed a deduction (or equivalent benefit) for each child that at least equals the subsistence cost of raising a child. Third, any benefits provided to low and middle income parents need not be extended to affluent parents. Other goals of the tax system, like low marginal rates and vertical equity, may influence the decision of whether these benefits should be extended. Finally, the Article used these principles to make suggestions for changes in current law. The major recommendation was that the $2500 deduction for each child be replaced by a $600 credit.

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[174] *See supra* Table II.

[175] For a similar suggestion, see George K. Yin et al., *Improving the Delivery of Benefits to the Working Poor: Proposals to Reform the Earned Income Tax Credit Program*, 11 AM. J. TAX POL'Y 225, 280–86 (1994).